Supreme Court, U.S.
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No.____

IN THE

Supreme Court Of The United States

October Term, 1996

THE REGENTS OF THE UNIVERSITY OF CALIFORNIA,

Petitioner,

v.

DONNA E. SHALALA, Secretary
Department of Health and Human Services;
PROVIDER REIMBURSEMENT REVIEW BOARD,

Respondents.

Petition for a Writ of Certiorari to the
United States Court of Appeals
for the Ninth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

As it is relevant to this action, the Medicare Act and regulations provide that hospitals furnishing services to Medicare beneficiaries should be reimbursed for the "reasonable cost," including direct and indirect costs, of such services. Such indirect, reimbursable, reasonable costs include the interest charges on loans required to enable the hospital to provide these services to Medicare beneficiaries. Congress and the Secretary recognize that from time to time cash flow irregularities may force a Medicare provider to borrow working capital and that the reasonable costs of such loans are reimbursable expenses. Regulations implementing the Medicare program provide, however, that such reimbursable costs cannot include interest expenses which are unreasonably high or are paid on unnecessary loans. Here, the hospital providers, owned and operated by Petitioner, had significant cash flow problems during the 1980's which necessitated borrowing for working capital. The provider hospitals had no legal ability to borrow in their own name. Consequently, Petitioner loaned the provider hospitals working capital funds from its short-term investment pool of University funds at an interest rate well below market rates. Moreover, the interest rates were below the income expected from the funds had the University been able to invest the money in other ways. Since the interest payments on the working capital loans were paid by the hospital providers to a related entity - i.e., Petitioner - the Medicare program denied reimbursement based on one of its Medicare regulations which presumes that loans between related entities are unnecessary and thus, improper. The question presented for review is:

1. Whether the Secretary's irrebuttable presumption that all interest charges on loans, between The Regents and its hospitals, are unnecessary, unreasonable, and improper costs is arbitrary, capricious, an abuse of discretion, and not in accordance with law.

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PETITION FOR A WRIT OF CERTIORARI

Petitioner, The Regents of the University of California (the "University" or "Petitioner") respectfully requests that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit, entered on April 17, 1996.[1]

OPINIONS BELOW

The United States Court of Appeals for the Ninth Circuit issued a judgment and an opinion. The opinion is reported at 82 F.3d 291, and is reprinted in the Appendix as Appendix A.

[1] All parties are named in the caption. Petitioner, The Regents of the University of California, is a constitutional, not-for-profit, educational institution (corporation) operated for the public benefit. Therefore, no Rule 29.1 statement is required.

The opinion of the United States District Court for the Central District of California is not reported. It is reprinted in the Appendix as Appendix B.

There are two administrative decisions concerning this case. Respondent, the Provider Reimbursement Review Board ("PRRB"), is the administrative tribunal with jurisdiction to hear and review Medicare reimbursement disputes. Its decision in this matter, PRRB Dec. No. 93-D41, is reported in Medicare & Medicaid Guide (CCH), ¶ 41,453 (May 14, 1993), and is reprinted in the Appendix at A-33. The Administrator of the Health Care Financing Administration ("HCFA") is the agent of Respondent, the Secretary of the Department of Health and Human Services (the "Secretary"), with authority for reviewing PRRB administrative decisions. The decision of the PRRB is final unless the Secretary, through HCFA, on her/his own motion, reverses or modifies it. The Administrator of HCFA decided not to reverse or modify the decision of the PRRB in this case. The Administrator's decision is not reported and is reprinted in the Appendix as Appendix D.

JURISDICTION

The judgment of the United States Court of appeals for the Ninth Circuit was entered on April 17, 1996. This Court has jurisdiction to review the judgment of the court of appeals by writ of certiorari pursuant to 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

The University asserts that the Secretary's interpretation of the Medicare Act and implementing regulations concerning the proper reimbursement for interest on working capital loans between the University and its hospital providers was arbitrary, capricious, an abuse of discretion and not in accordance with law. The relevant statutory section, 42 U.S.C.

§ 1395x(v)(1)(A), and regulation, 42 C.F.R. § 413.153, are set forth in the Appendix at A-53 and A-49 respectively.

STATEMENT OF THE CASE

Petitioner, The Regents of the University of California is, pursuant to Article IX, section 9 of the California Constitution, the operator of the University of California and all its administrative departments and divisions. (A-68) These various administrative divisions include five existing medical schools and their associated acute care hospitals. All of these five University hospitals are medicare providers under the medicare program. Well over one fifth of the care provided by these hospitals is provided to patients within the medicare program. (See, Appendix H.)

The University providers involved in this appeal are the University of California, Los Angeles Medical Center ("UCLAMC"), University of California, Irvine Medical Center ("UCIMC"), and University of California, San Diego Medical Center ("UCSDMC"). Each are general acute care hospitals licensed to Petitioner, and are providers of services under the Medicare Act. Each medical center disputes denial of reimbursement of Medicare's share of interest expense on necessary and proper working capital loans made to the hospitals by Petitioner. UCLAMC raises this issue with regard to its reimbursement for fiscal years ending June 30, 1982, and June 30, 1983. UCIMC raises this issue with regard to its reimbursement for fiscal years ending June 30, 1983 and June 30, 1985. UCSDMC raises this issue with regard to its reimbursement for fiscal years ending June 30, 1982 and June 30, 1984. The amount of Medicare reimbursement in dispute for all the fiscal years in contention is approximately $1,600,000. (See, Appendix H.)

The University's provider hospitals' requests for Medicare reimbursement for interest expenses on working capital loans was denied by the fiscal intermediary, an agent of the

Secretary with responsibility for reviewing provider requests for Medicare reimbursement. (A-34)

All three University providers appealed from the intermediary's (Blue Cross') decision not to reimburse each for interest expense on loans from Petitioner. Under special administrative proceedings available to the three providers before the PRRB, all their appeals for the fiscal years listed above were consolidated for hearing because the gravamen of each appeal was the same "legal" question and because the factual differences between each provider's "appeal" were *de minimis*. In the end, even these small differences were eliminated by an agreement between the University providers and the intermediary to proceed by way of a stipulation of facts and briefs on the law. See, § 1878(f)(1), title XVIII of the Social Security Act and 42 C.F.R. § 405.1837(b). (See, Appendix H.)

As stated above, the underlying facts that constitute the "heart" of the record below are set forth in a stipulation reached between the intermediary (Blue Cross) and the provider at the hearing before the PRRB. This stipulation of facts ("Stipulation of Facts") is set forth in the Appendix at A-66. Both the intermediary and Petitioner agreed to have the PRRB decide the case on the basis of the Stipulation of Facts and no other evidence was presented by either side. Consequently, the PRRB heard no live testimony and determined the case on the basis of the application of medicare law and implementing regulations to the facts as set forth in that stipulation. Among those facts set forth in the Stipulation of Facts is the following: "Funds obtained [working capital loans made by Petitioner to the three provider hospitals] were used for necessary and proper purposes related to patient care within the meaning of 42 C.F.R. § 413.9." (Emphasis added.) Stipulation of Facts, number 11 (A-70)

As the facts before the PRRB disclose, Petitioner submits its proposed annual budget to the Governor in August of

the year prior to the beginning of its fiscal year (July 1). The Governor's budget for the University includes a line item by line item detail of Petitioner's annual budget. Beginning in fiscal year 1975-1976, as a result of severe fiscal problems within the University's hospitals, the California legislature appropriated a twenty-five million dollar ($25,000,000) fund entitled "University of California Teaching Revolving Fund" ("Fund"). The purpose of the Fund was to supplement petitioner's hospital need for working capital and to assure that the hospitals could meet employee salaries, contractor demands and other daily charges without endangering the continuity of its care of patients. In the mid-1980's, the California legislature terminated the fund due to state financial problems. (A-71)

The abrupt withdrawal of twenty-five million dollars ($25,000,000) of state support from the University's hospitals (including the three providers involved in this appeal) created a financial crisis for these hospitals. None had the legal capacity to borrow money from outside sources. Consequently, Petitioner began making loans to the hospitals to cover working capital needs.[2] The loans carried a preferential interest rate well below market and less than Petitioner would have obtained from investing the funds in the commercial market. Moreover, Petitioner could not effectively borrow money on behalf of its hospital's in the open market because of exorbitant market interest rates. (A-69 and A-70)

As stated above, under the Medicare program, providers of services to medicare patients are reimbursed for the "reasonable costs" of providing these services. 42 U.S.C. §§ 1395f(b) and 1395l(a). The term "reasonable costs" is defined broadly in 42 United States Code section 1395x(v) which provides, in part that:

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[2] The University's funds are allocated by budget authorization by the California Legislature. The hospitals are expected to support themselves from patient payments.

> "(b)(1)(A) the reasonable cost of any services shall be the cost actually incurred, excluding therefrom any part of incurred cost found to be unnecessary in the efficient delivery of needed health services, and shall be determined in accordance with regulations establishing the method or methods to be used, and the items to be included, in determining such costs for various types or classes of institutions, agencies, and services;"

42 U.S.C. section 1395x(v)(1)(A).

Applicable Medicare regulations also state that "reasonable costs" are to be defined to include:

> all necessary and proper expenses incurred in furnishing services, such as administrative costs, maintenance costs, and premium payments for employee health and pension plans. *It includes both direct and indirect costs and normal standby costs.*

42 C.F.R. § 413.9(c)(3).

The term "necessary and proper" costs is similarly defined broadly to mean "costs that are appropriate and helpful in developing and maintaining the operation of patient care facilities and activities." 42 C.F.R. § 413.9(b)(2). The regulations provide that these general principles may be supplemented by more specific regulations providing that the "reasonable cost of any services must be determined in accordance with regulations establishing the method or methods to be used, and the items to be included." 42 C.F.R. § 413.9 (b)(1).

One such regulation promulgated by the Secretary pursuant to the above statutory authority is 42 C.F.R. 405.419[3] and

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[3] This regulatory provision was redesignated 42 Code of Federal Regulations section 413.153 in 1986. (See Appendix E.) No substantive changes were made to the regulation as a result of the redesignation. In light of the fact that 42 C.F.R. § 405.419 was consistently used throughout

the proper interpretation of this regulation is the subject of this petition.

42 C.F.R. § 405.419 provides that an allowable cost for reimbursement includes "necessary and proper interest on both current and capital indebtedness." 42 C.F.R. § 405.419(a). The regulation further provides that "proper" interest must "be incurred at a rate not in excess of what a prudent borrower would have had to pay at the time of the loan" and "be paid to a lender not related by control or ownership or personal relationship to the borrowing organization." 42 C.F.R. § 405.419(b)(3)(i) and § 405.419(b)(3)(ii).

According to the Secretary, the objective of this regulation prohibiting Medicare reimbursement for interest paid between related parties is to avoid paying collusive or improperly inflated interest costs which may be brought about by transactions between closely related entities who are motivated by a desire to increase profits.

42 C.F.R. § 405.419(c).

Generally, contrary to 42 C.F.R. § 405.419(c), Medicare regulations allow a provider to claim the costs incurred by its related party owner or operator in connection with the operation of the hospital's programs.

> [C]osts applicable to services, facilities, and support furnished to the provider by organizations related to the provider by common ownership or control are includable in the allowable cost of the provider at the cost to the related organization. However, such cost must not exceed the price of comparable services, facilities, or supplies that could be purchased elsewhere.

42 C.F.R. § 413.17(a).

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all the earlier papers in this case, Petitioner will continue to refer to 42 Code of Federal Regulations section 413.153 under its prior designation, Code of Federal Regulation section 405.419.

The Secretary has always so interpreted the regulations. For example, in guidelines issued to private entities who administer the Medicare program (intermediaries), the Secretary identified certain costs incurred by related medical schools which could be included in a provider's GME costs, including costs of a medical library, physician office space and clerical support. Intermediary Letter 78-7 ("IL 78-7"). Those costs normally would be incurred directly by a hospital that operated GME programs independently of a related medical school. Id. Similarly, in the case of working capital loans, the University hospitals involved in the petition would have incurred interest expenses on market-place loans but for the fact that it was legally precluded from borrowing in its own name.

However, with regard to interest on loans between related parties, the Secretary has interpreted such costs to be non-reimbursable under the Medicare program pursuant to 42 C.F.R. § 405.419 and contrary to the general rule. The PRRB[4], the Secretary[5], the district court[6], and the Ninth Circuit Court of Appeals[7] have now all held that reimbursement for such expenses is not allowable because the loans were made between related parties--Petitioner and the three providers. The Ninth Circuit's decision was based entirely on the court's determination that 42 C.F.R. § 405.419, acts as an absolute bar to reimbursement and that no exception can be made for the University providers even where the facts disclose that the loans were absolutely necessary for the care of the Medicare patients in the facilities, the hospitals could borrow from no other entity, and the interest rates were proper and well below market rates saving the Medicare program hundreds of thousands of dollars.

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[4] Appendix at C.

[5] Appendix at D.

[6] Appendix at B.

[7] Appendix at A.

Petitioner's contrary position is straightforward. 42 C.F.R. § 405.419 was enacted in order to implement Congress's intent that only necessary or proper Medicare expenses be reimbursed. Where loans are made between related parties and interest charged, the arrangement is suspect because the indicia of "arms-length" negotiations is not present. Consequently, on loans made between related parties exorbitant interest rates might be charged in order to maximize Medicare reimbursement or the loans may be made when no need to borrow exists, but a desire to invest in the related entity is present. Such "suspect" loans are therefore presumed to be unreimburseable because they are *presumed* to be unnecessary and improper. Petitioner accepts this presumption against the reimburseability of the provider's interest payments. However, Petitioner vigorously contests the Ninth Circuit's determination that the presumption is irrebuttable. Where the provider can prove that the loans made between related parties are necessary and the interest rates charged were proper, the presumption against reimbursement is countered and payment for patient care services should be made by the Medicare program, consistent with the general rule that related party costs in support of the Medicare program should be reimbursed.

Every appellate court that has reviewed the Secretary's inflexible interpretation of the related party rule, 42 C.F.R. § 405.419, as it applies to the reimbursement of interest expense between entities which do not have a profit motive, *except for the Ninth Circuit*, has rejected it. Instead, the courts have consistently tempered the force of the prophylactic rule in order to permit special exceptions to the general ban when consistent with the expressed intent of the regulatory scheme and the purposes of the Medicare Act. See, *Trustees of Indiana University v. United States*, 618 F.2d 736 (1980) at 736 (see Appendix G;) *Northwest Hospital, Inc. v. Hospital Services Corp.*, 687 F.2d 985; (7th Cir. 1982); *Jackson Park Hospital Foundation v. United States*, 659 F.2d 131 (1981); *Shaker Medical Center Hosp. v. Secretary of Health*, 686 F.2d

1203 (6th Cir. 1982); and *University of Cincinnati v. Heckler*, 723 F.2d 1171 (6th Cir. 1984)

Petitioner brought suit in the district court under Title XVIII of the Social Security Act, 42 U.S.C. § 1395 et seq., commonly known as the Medicare Act. Jurisdiction in the district court was proper pursuant to 42 U.S.C. § 1395oo(f). There, on cross-motions for summary judgment, the court determined that the Secretary's interpretation of the regulatory bar to reimbursement for related party interest expenses (42 C.F.R. § 405.419) was reasonable and entitled to deference.

The district court's memorandum and order is dated September 6, 1994. On September 21, 1994, Petitioner timely appealed the district court's decision to the court of appeals. In a judgment and decision filed on April 17, 1996, the court of appeals affirmed the district court's decision.

REASONS FOR GRANTING THE WRIT

I. The Ninth Circuit's Judgment Should be Reviewed Because It Conflicts with Other Circuit Decisions Interpreting 42 C.F.R. § 405.419.

The facts analyzed by the Court of Claims when it decided *Trustees of Indiana University v. United States*, (1980) 618 F.2d 736 (Appendix G) are substantively indistinguishable from the facts underlying this appeal and the Court of Claims ordered reimbursement of the Medicare provider's related-party interest expense. The salient facts which arise in both Trustees of Indiana University and this case are as follows: (1) the non-profit provider(s) is affiliated with a state university, (2) the state appropriates no money for the hospital, (3) the hospital is prohibited by state law from borrowing from outside sources, (4) and the University lends the hospital essential funds necessary for medicare patient care at less than the rate of interest available in the marketplace.

In *Trustees of Indiana University*, the court found that the relationship of the hospital provider to the University and

to the State of Indiana was special. The hospital was a state teaching hospital, but received no money from the State for its operations. Although the State of Indiana provided funds for the University, state law prohibited the use of any of those funds for the hospital. Since the hospital was not a separate legal entity, it could not borrow money from outside the University. If the hospital could not support itself through the fees it collected from patients, it had to borrow from the University itself. It did so and the interest rate charged by the University on the loan was less than the prime rate.

The salient facts underlying this appeal are substantially the same. All three University hospitals involved in this appeal are state teaching hospitals and received no money from the State of California for their operations. Indeed, prior to the years involved in this appeal, the State of California had provided to Petitioner a $25 million revolving fund specifically designated to defray the University hospitals' losses. Part of the reason that the University hospitals desperately needed working capital funds during the appeal period is because the state abruptly discontinued this fund beginning in fiscal year 1980-1981 because of serious California state budget shortages. (A-71) None of the University medical centers had the legal ability to borrow money from anyone other than Petitioner. The University hospitals borrowed money from Petitioner to cover necessary operating shortfalls and the loans were instrumental for their continued operation. (A-70) The interest rates charged by Petitioner to the University hospitals for these working capital loans was far less than the rate a prudent borrower would have had to pay in the commercial market at the time the loans were made. (A-69) Indeed, these interest rates were lower than the amount Petitioner was receiving for the investment of its short-term excess funds in the market place. (A-70) Finally, the funds borrowed by the University hospitals from Petitioner were neces-

sary for continued hospital operation and the interest rates were appropriate. (Appendix A-70.)[8]

The Court of Claims in *Trustees of Indiana University* found that a literal reading of 42 C.F.R. § 405.419 without regard to other, relevant regulatory provisions, the stated purpose of the regulation itself and to the underlying statute would bar reimbursement for the interest expenses incurred by Indiana University. The court found that Indiana University was related to the University hospital because it was the operator of that hospital. Consequently, Indiana University would not be eligible for medicare reimbursement of interest expenses on loans to the hospital because of that relationship if C.F.R. § 405.419 was read strictly. However, the court *did* find that Indiana University was entitled to medicare reimbursement of its interest charges. It did so without invalidating 42 C.F.R. § 405.419. It did so, in spite of the fact that it approved of the prophylactic purpose underlying 42 C.F.R. § 405.419. The Court of Claims, quoting the Supreme Court, held it is a "familiar rule, that a thing may be within the letter of the statute and yet not within the statute, because not within

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[8] The Ninth Circuit attempts to distinguish the facts of this case from the facts considered by the Court of Claims in *Trustees of Indiana*. In order to do so, it highlights the fact that the hospital provider in *Trustees of Indiana* never received state funds directly from the state of Indiana and was prohibited from receiving state funds. On the other hand, the Ninth Circuit states that the State of California had provided funds to the University providers in the 1970's. The decision not to fund Indiana University Hospital directly with state funds was a decision made by Indiana's legislature. The decision not to fund Petitioner's hospitals directly with state funds in the 1980's was a decision made by California's legislature. The Trustees of Indiana, its hospital provider, The Regents of the University of California and its hospital providers had no authority to make these state budgetary decisions. The end result in both cases is this: *no state funding for the hospitals.*

The Ninth Circuit also states that the University had funded its hospital providers on an interest-free basis in the past. (A-9) There is no record authority for this statement.

its spirit, nor within the intention of its makers. (Citing *United Steelworkers of America v. Weber*, 443 U.S. 193 (1979).)" "Indeed, if the 'plain meaning' of a statute produces an 'unreasonable' result 'plainly at variance with the policy of the legislation as a whole' the courts have 'followed that purpose, rather than the literal words.' " (Citing, *United States v. American Trucking Associations, Inc.*, 310 U.S. 534, 543 (1940).) *Trustees of Indiana University*, *supra*, 618 F.2d at 737.

The Court of Claims in *Trustees of Indiana University* was swayed by the fact that many of the evils inherent in collusive loans between an entity and its owner or operator are not present in a loan between a state university and its associated university hospital. Like religious organizations, neither party has a profit motive. To the contrary, Indiana University, like Petitioner in this case, could have received a greater return on its money by investing it elsewhere. The concern embodied in 42 C.F.R. § 405.419 — to protect the government and its medicare program from paying the cost of collusive loans with inflated interest rates designed to benefit enterprises associated with providers of medicare services - is simply not present in either the Trustees of Indiana University situation or the situation below involving Petitioner. Consequently, the Court of Claims in Trustees of Indiana University carved out a specific and limited exception to the regulatory bar when these circumstances exist: the interest rates are clearly below market, the loan funds are used for clearly necessary patient care purposes and, because of the special relationship of the provider and its operator, no profit motive is present.

The plain fact is, if Petitioner's hospitals could have borrowed money on their own from outside commercial lenders, the interest rates would have been higher and the medicare program would have reimbursed those rates. Similarly, if Petitioner had borrowed money from outside, commercial lenders to meet the needs of its provider hospitals, the interest

rates would have been higher and the Medicare program would have reimbursed those rates. Clearly, the fact that the University hospitals borrowed money from Petitioner at significantly lower rates than were available in the open market, ultimately benefits the Medicare program.[9]

II. Respondents' Interpretation of 42 C.F.R. § 405.419 Establishes a Preference for Religion Which Violates the First Amendment

Respondents and the courts below have interpreted 405.419 as an absolute bar to reimbursement of interest expenses on monies borrowed to care for medicare patients when the loan is between related parties. However, 42 C.F.R. § 405.419(c)(2) creates an exception to the regulation where the provider borrows from a related religious order: "In addition, if a provider operated by members of a religious order borrows from the order, interest paid to the order is an allowable cost." The PRRB recently confirmed this exceptional treatment for interest on loans between a provider and its related religious order in St. Elizabeth Hospital v. Blue Cross and Blue Shield Association/Empire Blue Cross and Blue Shield (September 17, 1993) PRRB Dec. No. 93-D91.

Since 42 C.F.R. § 405.419 was established by the Secretary to assure that the medicare program would not be reimbursing costs to a provider which were in reality inflated interest rates charged by a collusive related party, this exception for providers operated by a religious order makes sense: the religious order and the provider are not governed by the profit motive. However, this preference for religious orders cannot stand scrutiny under the First Amendment's establishment clause unless similarly situated non-religious operators are likewise exempt.

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[9] If Petitioner had borrowed money from outside commercial lenders at the available interest rates, the Medicare program could have reimbursed *its share* of the higher interest expense. Approximately 75 percent of the interest charges would be unreimbursed.

It is for this reason Petitioner argued before Respondents and the courts below that 42 C.F.R. § 405.419 be construed as the creation of a rebuttable presumption that interest charges on loans between related parties will not be reimbursed. This interpretation permits medicare reimbursement in the exceptional case where the profit motive does not contaminate the loan. The relationship of Petitioner to UCLA Medical Center, UCI Medical Center, and UC San Diego Medical Center is precisely the same as that of a religious order to its hospital provider in the respect that none of these entities have a proprietary or commercial motive relative to the interest rates charged on the borrowings. Consequently, to treat the University providers differently than the provider operated by a religious order creates constitutional difficulties within the regulation. On the other hand, if the regulation is viewed as a rebuttable presumption, as Petitioner has suggested, and consistent with the approach taken by the Court of Claims, the Sixth Circuit, and the Seventh Circuit, the constitutional difficulties in the regulation are mitigated and the goals of the Medicare Act are preserved.

There may be several situations involving non-profit hospitals where borrowing powers are limited and necessary loans from related operators required. The concerns which led the Secretary to adopt 42 C.F.R. § 405.419 may simply not exist under these special circumstances. Indeed, the facts surrounding these special situations may be more like those surrounding loans between a provider and its related religious order than loans between a provider borrowing from a related for-profit corporation. Under these circumstances, to interpret this regulatory subsection as an irrebuttable presumption creates absurd results. This is particularly evident when one considers that the Secretary's interpretation of her own regulations permits a proprietary organization to advance funds to its related hospital and receive reimbursement under the medicare program for any interest expenses above its return on equity capital. 42 C.F.R. § 405.419(b)(2)(iii). Such an

option does not exist for Petitioner, which is exempt from taxation. The end result of this disparate treatment therefore, is that religious orders receive full reimbursement of any interest expenses they charge their related provider, for-profit corporations receive additional reimbursement for interest expenses in excess of their return on equity capital and Petitioner receives nothing for the cost of any loans to their related hospital providers other than "encouragement" to borrow money from outside lenders at high interest rates.

The Ninth Circuit ruled that Petitioner did not have standing to raise this First Amendment establishment clause issue. The Ninth Circuit misperceives the thrust of Petitioner's arguments. Petitioner argues that the exception found in 42 C.F.R. § 405.419(c)(2) is appropriate if it is construed to include similarly situated non-profit providers and operators which do not collaborate in the establishment of interest charges on loans between each other for the purposes of enhanced profit. Obviously, if this exception is read into the regulation, the regulation will serve a valid purpose, implement Congress's basic intent and not offend the establishment clause of the First Amendment. If, on the other hand, the Secretary's interpretation of 42 C.F.R. § 405.419 is allowed to stand, the section will create an impermissible distinction in treatment between religiously controlled providers on the one hand and similarly situated non-religiously controlled providers on the other. This disparate treatment of providers based solely on their religious or non-religious character is an obvious violation of the establishment clause: "Congress shall make no law respecting an establishment of religion. . . ." U.S. Constitution, Amendment I, clause 1.

Contrary to the Ninth Circuit's holding that Petitioner lacks standing to raise this issue, it is Petitioner's position that the court, *sua sponte*, should interpret the regulation in question so as to avoid any unconstitutionality under the establishment clause. This was the holding of the Court of Claims when it decided *Trustees of Indiana University*.

"Our conclusion is also supported by the settled principle that a statute should be construed so as to avoid any serious doubts concerning its constitutionality. E.g., *Califano v. Yamasaki*, 442 U.S. 682 (1979); *United States v. Vuitch*, 402 U.S. 62 (1971); *United States v. Rumely*, 345 U.S. 41 (1953). The same principle is equally applicable to administrative regulations. See *Rucker v. Wabash Railroad Company*, 418 F.2d 146 (7th Cir. 1969) at 149.

"As noted earlier, the regulation has an explicit exception for interest paid to a religious order by a provider operated by members of the order. Denying reimbursement of interest payments by a nonprofit hospital to its affiliated university while permitting reimbursement of payments to an affiliated religious order would raise serious questions under the first amendment, which generally prohibits the government from giving special favored treatment to a religious entity. E.g., *Committee for Public Education & Religious Liberty v. Nyquist*, 413 U.S. 756 (1973); *Lemon v. Kurtzman*, 403 U.S. 602 (1971). Our interpretation avoids that problem." (*Trustees of Indiana University*, *supra*, 618 F.2d at 740.)

As the Court of Claims stated in *Trustees of Indiana University*, there is no doubt that the First Amendment's establishment clause is implicated by the Secretary's narrow reading of 42 C.F.R. § 405.419(c)(2). In 1971, the United States Supreme Court fully articulated the now famous three-prong test used to determine violations of the establishment clause in *Lemon v. Kurtzman*, 403 U.S. 602 (1971). In Lemon, the court had before it statutes from Pennsylvania that provided for direct payments, either to the schools or to the instructors, of salary supplements for teachers of secular subjects.

The court found that the statutes had a secular purpose, as opposed to a religious purpose, thus satisfying the first element of its three-part test.[10] The other two prongs to the test are that the challenged program (1) must have a primary affect that does not advance religion and (2) must not result in excessive entanglement between government and religion. It is the second prong of the Lemon test--the clear advancement of religion--which dooms Respondents' construction of 42 C.F.R. § 405.419(c)(2) in the instant case.

Respondents' interpretation provides direct financial advantages to providers which are operated by religious organizations and denies the same reimbursement to similarly situated providers which are not operated by religious organizations. As the Ninth Circuit stated in *Brown v. Woodland Joint Unified School Dist.*, 27 F.3d 1373, (9th Cir. 1994) advancement of religion through governmental action is prohibited even where the advancement is unintentional. Moreover, ". . . a 'primary' affect encompasses even nominally 'secondary' affects of government action that directly and immediately advanced . . . religion."

A government practice has the effect of impermissibly advancing religion if it is "sufficiently likely to be perceived by adherents of the controlling denominations as an endorsement, and by the non-adherents as a disapproval, of their individual choices." *Grand Rapids School District v. Ball*, 473 U.S. 373 (1985), 390. The relevant inquiry "is whether the government's action actually conveys a message of endorsement of religion in general or of a particular religion." *Kreisner v. City of San Diego*, 1 F.3d 775, 783, (9th Cir. 1993), cert. den. (1994) 114 S.Ct. 690, 126 L.Ed.2d 657.

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[10] Historically, the government has had little trouble satisfying this prong of the test. In *Lemon* the court accepted the state's position that the additional payments had the secular purpose of improving the quality of the education received by children who attend church-related schools.

To determine whether the endorsement message is conveyed, the Ninth Circuit uses a reasonable observer standard. "This hypothetical observer is informed as well as reasonable; we assume that he or she is familiar with the history of the government practice at issue." *Kreisner v. City of San Diego, supra*, 1 F.3d at 784. There is no colorable argument that can be made to save Respondents' construction of 405.419(c)(2). Any informed, reasonable observer of Respondents' practice of reimbursing interest expense to providers who borrow funds from their religious operator but denying interest reimbursement to providers who borrow funds from their non-religious, non-profit operators, must conclude that religion is generally advanced by the interpretation.

III. The Decision Below Interprets 42 C.F.R. § 405.419 In a Manner Inconsistent With The Medicare Statute

In promulgating the Medicare Act in 1965, Congress made clear its intent that Medicare providers were to be reimbursed, as nearly as possible, for all costs necessarily incurred in the efficient delivery of health care services to Medicare beneficiaries. The Senate Report accompanying the Medicare Act states Congress' explicit intent:

> Although [reimbursement] may be made on various bases, the objective, whatever method of computation is used, will be to approximate as closely as practicable the actual cost (both direct and indirect) of services rendered to the beneficiaries of the program so that under any method of determining costs, the costs of services to individuals covered by the program will not be borne by individuals not covered, and the costs of services to individuals not covered, will not be borne by the program.

S. Rep. No. 404, 89th Cong., 1st Sess., reprinted in 1965 U.S.C.C.A.N. 1943, 1976.) This expression of Congressional purpose is codified in the Medicare Act where the Secretary is

directed to issue regulations for determining reasonable costs under the Medicare program. 42 U.S.C. § 1395x(v)(1)(A). There, Congress directed that the Secretary's regulations

> shall . . . take into account both direct and indirect costs . . . in order that, under the methods of determining costs, the necessary costs of efficiently delivering covered services to individuals covered by [Medicare] will not be borne by individuals not so covered, and the costs with respect to individuals not so covered will not be borne by [Medicare].

Id. (emphasis added).

The result of the Ninth Circuit's judgment affirming the district court decision here is exactly contrary to Congressional intent: it shifts the costs of providing services to Medicare beneficiaries to individuals not covered by the program. See *Ohio State University v. Sullivan*, 777 F. Supp. at 582 (1991) ("If the Medicare program did not pay its fair share of . . . costs, there is a likelihood that they would be shifted to non-Medicare patients in violation of the Medicare Act, 42 U.S.C. § 1395x(v)(1)(A) . . ."). Such a result is contrary to the meaning and purpose of the Medicare Act, and should not be allowed to stand.

CONCLUSION

For the foregoing reasons, Petitioner respectfully prays that the Court issue a writ of certiorari to review the judgment of the Court of Appeals for the Ninth Circuit.

Respectfully submitted,

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July 16, 1996

APPENDIX A

FOR PUBLICATION
UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 94-56475

D.C. No.
CV-93-04242-RSL

OPINION

Regents of the University of California,

Plaintiff-Appellant,

v.

Donna E. Shalala,* Secretary,
Health & Human Services;
Provider Reimbursement Review Board,

Defendants-Appellees.

Appeal from the United States District Court
for the Central District of California
Ronald S.W. Lew, Presiding

Argued and Submitted
March 6, 1996—Pasadena, California

Filed April 17,1996

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* Pursuant to P.L. No. 103-296, the Social Security Independence and Program Improvements Act of 1994, the function of the Secretary of Health and Human Services in Social Security cases was transferred to the Commissioner of the Social Security Administration, effective March 31, 1995. In accordance with section 106(d) of the Act, Shirley S. Chater, Commissioner of the Social Security Administration, is substituted for Donna E. Shalala, Secretary of Health and Human Services, as the defendant. Although the Secretary of Health and Human Services was responsible for the actions of the Social Security Administration at the time of its final decision in this case, we refer to the defendant as "the Commissioner" throughout this disposition for the sake of convenience.

Before: Harry Pregerson and Thomas G. Nelson, Circuit Judges, and David A. Ezra,** District Judge.

Opinion by Judge T.G. Nelson

SUMMARY

Health/Medicaid/MediCare And Government Assistance

The court of appeals affirmed a district court judgment. The court held that the district court did not err in granting summary judgment in favor of the Secretary of Health and Human Services in university regents' action challenging the Secretary's decision to deny Medicare reimbursement for patient expenses attributable to interest costs incurred on working loans from the regents to university hospitals.

Appellant the Regents of the University of California owns and operates three Medicare providers that are not separate legal entities from the Regents. The providers cannot perform certain legal functions in their own names, including borrowing monies from outside sources.

Regents made working capital loans to the providers, and the proceeds were used for patient care purposes. The providers filed claims for Medicare reimbursement for the interest expenses associated with the loans. The interest expense claimed on the loans was below then-existing market rates. The fiscal intermediary denied the claims on the basis of 42 C.F.R. § 405.419 (1985), which disallows reimbursement for interest expenses on loans between related organizations. Appellee the Provider Reimbursement Review Board affirmed the intermediary and disallowed the interest expense. The district court, on review, granted appellee the Secretary's motion for summary judgment. The Regents appealed.

** Honorable David A. Ezra, United States District Judge for the District of Hawaii, sitting by designation.

[1] Under the Medicare program, providers of services to Medicare patients are reimbursed for the "reasonable costs" of providing those services. **[2]** A precise definition of "reasonable cost" was left to the Secretary. **[3]** Congress did not require the Secretary to make exceptions to its policy on related party loans for arguably meritorious transactions that involve a specific type of related party. In this case, the Secretary's interpretation of the regulation was consistent with the regulation's plain language and the purpose of the related party restriction as set forth in the regulation. **[4]** Moreover, there was a valid policy reason for upholding the regulation as interpreted by the Secretary; if an exception in a previous case was adopted and the Secretary made exceptions for "necessary, below market rate" loans between nonprofit organizations and their related hospitals, then those organizations would have an incentive to recharacterize routine operating capital allocations as "loans." In addition, the regulations were designed to avoid case-by-case review.

[5] The prophylactic rule barring reimbursement for interest expenses on loans between related organizations does not violate due process rights under the Medicare Program.

[6] Regents did not have standing to challenge the constitutionality of the Secretary's interpretation of an exception to the related party interest preclusion for cases where the provider borrows from a related religious order. Regents failed to establish that it would suffer injury as a result of the exception for religiously affiliated providers.

[7] Regents offered no evidence that a favorable decision would sufficiently redress the injury or potential injury.

COUNSEL

Robert Barnes, Oakland, California, for the plaintiff-appellant

Russell W. Chittenden, Assistant United States Attorney, Los Angeles, California, for the defendant-appellee.

OPINION

T.G. NELSON, Circuit Judge:

OVERVIEW

Regents of the University of California ("Regents") appeals the district court's summary judgment in favor of the Secretary of Health and Human Services in Regents' action under Title XVIII of the Social Security Act, 42 U.S.C. § 1395oo(f)(a), challenging the Secretary's decision to deny Medicare reimbursement for patient expenses attributable to interest costs incurred on working loans from Regents to three University hospitals ("providers").

We have jurisdiction under 28 U.S.C. § 1291, and we affirm.

FACTS AND PROCEDURAL HISTORY

Regents owns and operates the three Medicare providers on whose behalf this appeal is taken, UCLA Medical Center, UC Irvine Medical Center, and UCSD Medical Center. The providers are not separate legal entities from the Regents and, as such, cannot sue, be sued, enter into contracts, or perform other legal functions in their own names, including borrowing monies from outside sources.

In 1982, 1983, 1984, and 1985, Regents made working capital loans to the providers. It is undisputed that the proceeds from the loans were used for necessary and proper purposes related to patient care. These loans were necessitated by a budget shortfall resulting from a decrease in funding from the state legislature.

The providers filed claims for Medicare reimbursement for the interest expenses associated with these loans. The claims were initially reviewed by the fiscal intermediary, Blue Cross in this case, and were denied on the basis of 42 C.F.R. § 405.419 (1985), which disallows reimbursement for interest expenses on loans between related organizations. Regents appealed to the Provider Reimbursement Review Board ("PRRB"), which affirmed the intermediary and disallowed the interest expense. On review, the district court granted the Secretary's motion for summary judgment.

ANALYSIS

1. Standard of Review

We review a grant of summary judgment *de novo*. *Rendleman v. Shalala*, 21 F.3d 957, 960 (9th Cir. 1994). Judicial review of Medicare reimbursement disputes under 42 U.S.C. § 1395oo(f)(1) is governed by the Administration Procedure Act, 5 U.S.C. §§ 701-706 ("APA"). Under the APA, "[r]eview is limited to determining whether the Secretary's action was arbitrary, capricious, and abuse of discretion, not in accordance with law, or unsupported by substantial evidence on the record taken as a whole." *Vallejo Gen. Hosp. v. Bowen*, 851 F.2d 229, 231 (9th Cir. 1988).

When the meaning of a provision within the expertise of an agency is involved, the agency's expertise makes it particularly suited to interpret the language. *Pacific Coast Medical Enters. v. Harris*, 633 F.2d 123, 131 (9th Cir. 1980). In such cases, we will generally afford deference to the agency's construction of its own regulation.

Review of an agency's interpretation of its regulations involves a two-pronged analysis. First, we look to the plain language of the regulation. The words of the regulation must be "reasonably susceptible to the construction placed upon them by the Secretary, both on their face and in light of their prior interpretation and application." *Id.* Second, "the Secre-

tary's construction must be reviewed in relation to the governing statute." *Id.* "Agency regulations must be consistent with and in furtherance of the purposes and policies embodied in the Congressional statute which authorize them." *Id.*

II. Statutory Interpretation

Initially, Regents challenges the Secretary's interpretation of § 405.419(b)(3)(ii), which disallows reimbursement for interest expenses on loans between related organizations. There is no dispute that the providers and Regents are related entities. Further, there is no dispute that the interest expense claimed on the instant loans was below then-existing market rates. Thus, we must determine whether the plain words of the regulation are "reasonably susceptible to the construction placed upon them by the Secretary, both on their face and in light of their prior interpretation and application," *Pacific Coast*, 633 F.2d at 131, and whether the Secretary's application of the prophylactic rule, which deems all expenses arising out of loans between providers and their related organizations *per se* unreasonable, is contrary to Congressional intent.

[1] Under the Medicare Program, as established by Title XVII of the Social Security Act (42 U.S.C. §§ 1395-95rr), providers of services to Medicare patients are reimbursed for the "reasonable costs" of providing these services. The terms "reasonable costs" is generally defined in 42 U.S.C. § 1395x(v)(1)(A):

> [T]he reasonable cost of any services shall be the cost actually incurred, excluding therefrom any part of incurred cost found to be unnecessary in the efficient delivery of needed health services, and shall be determined in accordance with regulations establishing the method or methods to be used, and the items to be included in determining such costs for various types or classes of institutions, agencies, and services. . . .

[2] The precise definition of "reasonable cost" was left to the Secretary. Pursuant to that authority, the Secretary promulgated 42 C.F.R. § 405.419 (1985). Subsection(a) of § 405.419 provides that "[n]ecessary and proper interest on both current and capital indebtedness is an allowable cost." Under subsection (b)(2)(i) of § 405.419, interest is "necessary" if it is "incurred on a loan made to satisfy a financial need of the provider." Further, interest must be "proper," which requires interest to be "incurred at a rate not in excess of what a prudent borrower would have had to pay in the money market existing at the time the loan was made," § 405.419(b)(3)(i), and be "paid to a lender not related through control or ownership, or personal relationship to the borrowing organization." § 405.419(b)(3)(ii).

Regents asserts that the Secretary's interpretation of § 405.419 to deny reimbursement of interest on operating loans Regents made to its providers "runs afoul of Congressional intent that proper and necessary medicare patient expenses be reimbursed by the medicare program . . . ." Regents argues that because the regulations make exception for § 405.419 in certain related party transactions, other exceptions must be recognized where interest rates on loans between related entities are reasonable, the loan proceeds are necessary for patient care, and the related parties have no profit motive. Regents further contends that the scope of the prophylactic rule in (b)(3)(ii) is defined by the language in § 405.419(c)(1), which states: "The intent of this provision is to assure that loans are legitimate and needed and that the interest rate is reasonable." Thus, according to Regents, the effect of § 405.419(b)(3)(ii) together with (c)(1) is to disallow reimbursement of interest costs on loans between related parties *unless* the loans are necessary, related to patient care, and are made at reasonable interest rates. Regents thus reads the reasons expressed in (c)(1) as exceptions to the general rule of non-reimbursement.

In support of its argument, Regents cites *Trustees of Indiana Univ. v. United States*, 618 F.2d 736 (Ct. Cl. 1980). In *Indiana*, the hospitals, although not owned by the University, were a part of the University and its medical center. *Id.* At 737, 740. The court found that the relationship of the hospitals were state institutions, but, unlike the University, received no money from the state for their operations. Further, although the University received funds from the State of Indiana, Indiana state law prohibited the University from using any of those funds for the hospitals. *Id.* At 737. Because the hospitals were not separate legal entities, they could not borrow money from outside the University. *Id.* As such, the hospitals' only source of funds, other than from collection of fees, was through loans from the University. *Id.*

Presented with those particular circumstances, the *Indiana* court held that the prophylactic rule under § 405.419 was inapplicable. *Id.* At 740-41. The court reasoned that "[t]he evils against which the prohibition is directed are no more present where the related person to which the payments are made is a university than where it is a religious order." *Id.* At 740. However, the court *expressly* limited the holding in *Indiana* to the particular facts of the case:

> In holding for the plaintiffs in this case, we stress the limited scope of our decision. We are not holding that interest payments to a related person are reimbursable wherever the particular relationship does not involve any of the evils against which the regulation is directed. Nor are we casting any doubt upon the authority of the Secretary to adopt his prophylactic regulation generally barring reimbursement of interest payments to related persons without inquiry into the particular circumstances.

Id.

In *Indiana*, the University received funds from the state, but pursuant to state law, those funds could not be diverted for

the use of the hospitals. *Id.* At 737. Further, the hospitals were prohibited by state law from receiving money from the State of Indiana. *Id.* Therefore, the only way for the hospital in *Indiana* to obtain operating funds was through the University.

Regents' arguments that *Indiana* applies here are unpersuasive. First, in the case at bar, the providers had received state funds in the past, and unlike the situation in *Indiana*, there is no state law prohibiting the providers from receiving funds from the state. Further, prior to the 1981 policy of charging interest on working capital, the providers received working capital *contributions* from the Regents. Thus, the holding in *Indiana* is a limited exception to the prophylactic rule, and as the *Indiana* court itself warned, its holding should be limited exclusively to the facts particular to that case.

[3] Second, Congress did not require the Secretary to make exceptions to its policy on related party loans for arguably meritorious transactions involving a specific type of related party. In fact, the Secretary's interpretation of the regulation is consistent with the plain language of the regulation and the purpose of the related party restriction as set forth in the regulation itself. Regents' argument that the reasons for the regulation found in (c)(1) should be read as exceptions to the general rule is contrary to the terms of the regulations and certainly to the Secretary's interpretation of the regulation.

Third, in *Goleta Valley Community Hosp. v. Schweiker*, 647 F.2d 894 (9th Cir. 1981), we were asked to access the statutory and constitutional validity of the related party interest rule of § 405.419(b)(3)(ii), and we held that the regulation was valid. Regents argues that *Goleta Valley* may be distinguished from this case because the related parties in *Goleta Valley* had a profit motive. However, there is no indication that the holding in *Goleta Valley* was influenced by this factor. In *Goleta Valley*, we held:

> Once a determination has been made that the organizations are related, the Board need not inquire into whether the reimbursements claimed were reasonable because Regulation [405.419(b)(3)(ii)] operates as a prophylactic rule and defines any charges in excess of actual costs as per se unreasonable.

Id. At 897.

[4] Moreover, there is a valid policy reason for upholding the regulation as interpreted by the Secretary. If the exception in *Indiana* were adopted and the Secretary made exceptions for "necessary, below market rate" loans between nonprofit organizations and their related hospitals, then those organizations would have incentive to recharaterize routine, operating captial allocations as "loans" in order to take advantage of the interest expense reimbursement policy of Medicare. In addition, the exceptions would swallow the rule, requiring the case-by-case review the regulations were designed to avoid.

III. Due Process

According to Regents, the effect of the prophylactic rule prohibiting reimbursement of interest expenses for loans between related parties is an irrebuttable presumption which violates Regents' right to due process. *Vlandis v. Kline*, 412 U.S. 441, 447 (1973) ("Statutes creating permanent irrebuttable presumptions have long been disfavored under the Due Process Clause of the Fifth and Fourteenth Amendments.").

Regents' argument lacks merit because the law regarding the constitutionality of irrebuttable presumptions in social programs has been well settled. *Weinberger v. Salfi*, 422 U.S. 749 (1975); *Goleta Valley*, 647 F.3d at 894. In *Salfi*, the Supreme Court approved of a *per se* rule defining the length of marriage needed to qualify for social security benefits "which sweeps more broadly than the evils with which they seek to deal." 422 U.S. at 784. The Court explained:

> The Constitution does not preclude such policy choices as a price for conducting programs for the distribution of social insurance benefits. . . . There is thus no basis for our requiring individualized determinations when Congress can rationally conclude not only that generalized rules are appropriate to its purposes and concerns, but also that the difficulties of individual determinations outweigh the marginal increments in the precise effectuation of congressional concern which they might be expected to produce.

Id. At 785.

Other courts have also rejected the irrebuttable presumption challenge to the prophylactic rule under § 405.419. In *Hillside Community Hosp. v. Mathews*, 423 F. Supp. 1168, 1176 (N.D. Cal. 1976), the court found that the classifications under § 405.419 had a reasonable basis: "[T]o assure that loans are legitimate and needed, and that the interest rate is reasonable." "[I]n the context of social welfare programs, a classification will not be voided just because it 'is not made with mathematical nicety or because in practice it results in some inequality.' " *Id.* (quoting *Danbridge v. Williams*, 397 U.S. 471, 485 (1970). "If there is some 'reasonable basis' for the rule, it must be upheld." *Id.*

In *Caylor-Nickel Hosp. Inc. v. Califano*, N.D. Ind., Civ. No. F 77-83 (Sept. 10, 1979), 1980 Medicare & Medicaid Guide (CCH) ¶30,718, citing *Salfi*, 422 U.S. 749, the court held that § 405.419(b)(3)(ii) did not create an unconstitutional irrebuttable presumption:

> *Salfi* dictates that this court reject Caylor-Nickel's characterization of 42 C.F.R. § 405.419(b)(3)(ii) as involving an irrebuttable presumption that all transactions involving organizations related to Caylor-Nickel were illegitimate. The regulation presumes only that many transactions between related institu-

> tions are not legitimate, not needed, or not at reasonable interest; the Secretary, acting under statutory authority, has made a policy choice that, in the words of *Salfi*, "limited resources would not be well spent in making individual determinations."

[5] In light of *Salfi*, *Hillside*, and *Goleta Valley*, we reject the argument that the prophylactic rule barring reimbursement for interest expenses on loans between related organizations violates due process rights under the Medicare Program. The Secretary has the authority to make a policy choice to exclude reimbursement for interest expense arising from loans between related entities.

IV. Establishment Clause

Next, Regents challenge the Secretary's interpretation of 42 C.F.R. § 405.419(c)(1),[1] the provision which precludes related party interest, and § 405.419(c)(2), the provision which creates an exception to the related party interest preclusion for cases where the provider borrows from a related religious order. Subsection (c)(2), provides: "[I]f a provider operated by members of a religious order borrows from the order, interest paid to the order is an allowable cost."

Regents argues that although it does not fall within the plain language of the (c)(2) exception, the Secretary should interpret the exception to cover secular, nonprofit organiza-

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[1] Section 405.419(c)(1) provides in part:

> To be allowable, interest expense must be incurred on indebtedness established with lenders or lending organizations not related through control, ownership, or personal relationship to the borrower. Presence of any of these factors could affect the "bargaining" process this usually accompanies the making of a loan, and could thus be suggestive of an agreement on higher rates of interest or of unnecessary loans. Loans should be made under terms and conditions that a prudent borrower would make in armslength transactions with lending institutions. . . .

tions such as itself. According to Regents, if the (c)(2) exception is interpreted categorically to disallow interest reimbursement for secular Medicare providers, it may create an unconstitutional preference for religion in violation of the First Amendment Establishment Clause of the United States Constitution.

Finding that Regents lacked standing to make a First Amendment challenge to the regulations, the district court did not reach the merits of this argument. Regents urges this court to interpret, *sua sponte*, the regulation so as to avoid any unconstitutionality under the Establishment Clause.

For the reasons discussed below, Regents' arguments are unpersuasive. At oral argument, it was conceded by Regents that it was not challenging the constitutionality of the regulation or the exception, in and of themselves. Rather, Regents' Establishment Clause challenge is directed at the *Secretary's interpretation* of the (c)(2) exception.

Regents maintains that the exception found in § 405.419(c)(2) would be appropriate if it was read to include similarly situated non-profit providers and operators who do not collaborate in the establishment of interest charges on loans between each other for the purposes of enhanced profit. Thus, Regents seeks to strike the Secretary's limitation on the exception itself. This, we decline to do. If we were to hold that the Secretary's interpretation of § 405.419(c)(2) violates the Establishment Clause, we would essentially be holding that § 405.419(c)(2) was unconstitutional, because the Secretary's interpretation is wholly consistent with plain language of the exception. In such case, our remedy would be to strike the exception rather than to rewrite the regulation to create new exceptions or to strike the entire regulation.

Before we reach the issue of the constitutionality of the (c)(2) exception, we must first determine whether Regents has standing to challenge the Secretary's interpretation of the exception under the Establishment Clause. Standing is reviewed

de novo. *United Union of Roofers No. 40 v. Insurance Corp. of Am.*, 919 F.2d 1398, 1399 (9th Cir. 1990). "A district court's factual findings on jurisdictional issues must be accepted unless they are clearly erroneous." *Reebok Int'l. Ltd. v. Marnatech Enter., Inc.*, 970 F.2d 552, 554 (9th Cir. 1992) (quotations omitted).

To establish standing, we must determine "whether the interest sought to be protected by the complaint is arguably within the zone of interests to be protected or regulated by the statute or constitutional guarantee in question." *Association of Data Processing Serv. Orgs., Inc., v. Camp*, 397 U.S. 150, 153 (1970). Thus, in order to have standing, the complainant must be aggrieved by the agency action within the meaning of the statute. *Id.* The complainant must establish that he has suffered injury-in fact. *Id.* However, potential injury may be sufficient to confer standing. *City of Rohnert Park v. Harris*, 601 F.2d 1040, 1048 (9th Cir. 1979).

[6] In this case, Regents does not have standing to challenge the constitutionality of the Secretary's interpretation of the (c)(2) exception. Regents failed to establish that it would suffer injury as a result of the (c)(2) exception for religiously affiliated providers. The district court determined that the potential injury to Regents from the application of the exception for hospitals affiliated with religious organizations is too attenuated to establish standing.

[7] Further, Regents offered no evidence that a favorable decision would sufficiently redress the injury or potential injury. A decision by this court that the Secretary could no longer permit religiously affiliated providers to include interest pursuant to the exception would not benefit Regents, as Regents would still be precluded from including interest by the other terms of the regulation. Without any evidence of injury to Regents as a result of the alleged unconstitutional interpretation of the regulation and without evidence that a favorable ruling redress the injury, the district court's deter-

mination that Regents lacked standing to raise this issue was not erroneous.

CONCLUSION

For the reasons stated above, the district court's summary judgment is AFFIRMED.

APPENDIX B

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

No. CV-93-4242-RSWL (Ex)

THE REGENTS OF THE
UNIVERSITY OF CALIFORNIA

Plaintiff,

v.

DONNA E. SHALALA, Secretary,
United States Department of
Health and Human Services,

Defendant.

Filed September 6, 1994
Clerk, U.S. District Court
Central District of California

Entered September 7, 1994
Clerk, U.S. District Court
Central District of California

ORDER

I. INTRODUCTION

Before the Court are the parties' cross motions for summary judgment. The matter came up for hearing on the Court's law and motions calendar on August 29, 1994. Now, having carefully considered all of the papers filed in support of and in opposition to the motions, the Court hereby GRANTS Defendant, Department of Health and Human Services' cross motion for summary judgment and DENIES Plaintiff, Regents of the University of California's motion for summary judgment.

II. BACKGROUND

Plaintiff, The Regents of the University of California ("The Regents") filed its complaint in this case asking the Court to review an administrative decision by the Provider Reimbursement Review Board ("the Review Board") denying it certain cost reimbursements under the Medicare program. The Regents' complaint arises out of a dispute over medical care provider reimbursements for its affiliated medical centers. These reimbursements initially are reviewed by "fiscal intermediary," which serves as the agent of Defendant, Department of Health and Human Services ("HHS") and evaluates a provider's claims for reimbursements at the end of each year. In the present case, Blue Cross/Blue Shield of California acted as the fiscal intermediary, initially denying the reimbursement requests at issue in this case.

Appeals from adverse decisions of a fiscal intermediary are heard by the Review Board, whose decisions are final unless the Secretary of HHS revises or modifies such a decision on her own motion. In this case, the Review Board heard and affirmed Blue Cross/Blue Shield's initial denial of The Regents' reimbursement requests and the Secretary took no further action on The Regents' claims. The Regents (the provider) has a right to judicial review in district court of the Review Board's final decision or any subsequent action taken by the Secretary. 42 U.S.C. § 1395oo(f). It is in this posture of review that the case is presently before the Court.

Specifically at issue in this case is The Regents' claim that it is entitled to reimbursement for interest expenses incurred on money it loaned to its UCLA, UC Irvine and UC San Diego medical centers. Defendant claims, and the Review Board held below, that reimbursement for such interest expenses is not available under applicable regulations because the loans at issue were between related parties, that is, the medical centers and The Regents. It is undisputed that the medical centers and The Regents are the same legal entity and

thus, related parties for purposes of the relevant regulations. Each UC medical center involved in this case has various claims for interest reimbursement for the years 1982 through 1985. These claims were consolidated for review in the administrative proceedings below, and are consolidated for purposes of this case as well.[1] The total amount of disputed interest expense that The Regents claims to be entitled to in this case is $1.6 million.

It is uncontested that the interest expense claimed on loans made by The Regents to its various medical centers during the years at issue was well below then-existing market rates.[2] Nonetheless, Defendant asserts that its regulation, 42 C.F.R. § 405.419 (1985) ("Regulation 405.419"),[3] prohibits reimbursement of The Regents for this interest because it was incurred through related party borrowing. Defendant justifies its regulation by asserting that it acts as a prophylactic rule to prevent abuses that could occur in lending transactions between related parties. Specifically, Defendant is concerned that without such a prophylactic regulation, unnecessary loans will be made, or excessive rates of interest charged on borrowings between related entities.[4] It is uncontested that there is no evidence of such abuses in this case. Defendant asserts,

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[1] Although the Regents is the lender in this case, it nonetheless stands as plaintiff in that its related medical centers are not independent legal entities and therefore lack the capacity to sue or be sued.

[2] The Regents asserts that the related party loans in question were necessitated by the fact that its providers did not have the legal capacity to borrow money from outside sources. The basis of such loans, however, is irrelevant to the question of whether Defendant's denial of reimbursement for expenses attributable to them was a reasonable interpretation of the relevant statute and regulations.

[3] This provision was redesignated 42 C.F.R. S 413.153 in 1986. No substantive changes have been made to the regulation.

[4] These justifications for the prohibition on related party interest reimbursement are outlined in the applicable regulation itself. 42 C.F.R. § 405.419(c) (1985) (redesignated as 42 C.F.R. § 413.153(c) (1993)).

however, that its regulation must nonetheless apply. Both parties have thus agreed that the issue presented to the Court is whether Defendant's application and interpretation of Regulation 405.419 disallowing reimbursement for related organization interest expenses, even when such expenses are in fact proper, was arbitrary and capricious, or otherwise improper under law.

At the administrative level, this case was decided on stipulated facts, with no oral argument having been heard by the Review Board. Thus, the case comes to this Court under the same stipulated factual record. In its motion, The Regents challenges both the Defendant's interpretation of Regulation 405.419, as well as its promulgation of that regulation under the Medicare statute. In addition, The Regents points to several potential constitutional problems raised by Defendant's interpretation of the regulation to argue that such interpretation is erroneous. The Regents points to these constitutional issues as support for its argument that Regulation 405.419 must be interpreted not as an absolute, prophylactic bar to reimbursement for related party interest expenses, but rather, as a rebuttable presumption that such expenses are not reimbursable. In this case, The Regents argues, the uncontested fact that its loans were proper serves to rebut that presumption.

III. STANDARD FOR ISSUANCE OF SUMMARY JUDGMENT

Summary judgment is appropriate when there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law. Fed. R. Civ. P. 56(c). The moving party bears the initial responsibility of identifying this absence of a genuine issue of material fact. *Celotex v. Catrett*, 477 U.S. 317, 323, 106 S. Ct. 2548, 2553 (1986). The nonmoving party, on the other hand, is required by Rule 56(e) to go beyond the pleadings and designate specific facts showing that there is a genuine issue for trial. *Id.* at 324, 106 S. Ct. at

2553. Nonmoving parties can meet this requirement by use of affidavits, depositions, interrogatories, or admissions on file. *Id.* However, conclusory allegations unsupported by factual data are insufficient to create a triable issue of fact so as to preclude issuance of summary judgment. *Exxon Corp. v. Federal Trade Comm'n,* 663 F.2d 120, 127 (D.C. Cir. 1980). The judge must view the evidence in the light most favorable to the nonmovant, with all justifiable inferences drawn in its favor. *Anderson v. Liberty Lobby*, 477 U.S. 242, 252, 106 S. Ct. 2505, 2512 (1986); *Pacific Express. Inc. v. United Airlines. Inc.*, 959 F.2d 814, 816 (9th Cir.), *cert. denied*, 113 S. Ct. 814 (1992).

Summary judgment is a particularly appropriate vehicle for resolving appeals from administrative agency determinations, since the agency itself serves as the fact finder, and the appeal is generally limited to questions of law. *First National Bank v. Smith*, 508 F.2d 1371, 1374 (8th Cir. 1974), *cert. denied*, 421 U.S. 930, 95 S. Ct. 1655 (1975); *see also* 10A A. Wright & C. Miller, *Federal Practice and Procedure* "§ 2733, at 366-67 (1983).

IV. DISCUSSION

Under the Medicare statute, medical care providers are to be reimbursed for the "reasonable costs" of services they provide Medicare patients. 42 U.S.C.A. § 1395f(b) (Supp. 1994). Regulations promulgated under this statute by HHS include within the definition of reasonable costs, "[n]ecessary and proper interest on both current and capital indebtedness." 42 C.F.R. S 405.419(a) (1) (1985); *see also* 42 U.S.C.A. § 1395x(v) (Supp. 1994) (defining reasonable costs and granting HHS the authority to promulgate explanatory regulations). Under applicable regulations, however, to be reimbursable, interest expense "must be incurred on indebtedness established with lenders . . . *not related through control. ownership or personal relationship to the borrower.*" 42 C.F.R. § 405.419(c)(1) (emphasis added).

A. Review of Defendants Regulatory Interpretations and Promulgation.

Review over administrative determinations made by the Review Board is governed by 42 U.S.C.A. § 1395oo(f)(1) (Supp. 1994), which specifically incorporates the standards of review contained in the Administrative Procedures Act ("APA"), 5 U.S.C. §§ 701-706. The APA requires that the district court "decide all relevant questions of law, interpret constitutional and statutory provision, and determine the meaning or applicability of the terms of an agency action." *Id.* § 706. Furthermore, under the APA, the court must "hold unlawful and set aside agency action, findings, and conclusions found to be . . . arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." *Id.* In this case, The Regents challenges both the Review Board's interpretation of the relevant Medicare regulation (Regulation 405.419) as well as HHS's initial promulgation of that Regulation under the Medicare statute.

1. Defendant's Interpretation of its Regulation.

a. Standard of review.

Courts generally give considerable deference to any agency interpretation involving an issue within that agency's particular expertise. *Pacific Coast Medical Enters. v. Harris*, 633 F.2d 123, 131 (9th Cir. 1980). "This is especially true when an agency's own regulation is involved, and ordinarily, its construction will be affirmed if it is not clearly erroneous or inconsistent with the regulation." *Id.* (citing *Udall v. Tallman*, 380 U.S. 1, 16-17, 85 S. Ct. 792, 801 (1965)) (emphasis added). While a large degree of deference is given to such agency determinations, " 'the deference owed to an expert tribunal cannot be allowed to slip into a judicial inertia.' " *Id.* (quoting, *American Ship Building Co. v. NLRB*, 380 U.S. 300, 318, 85 S. Ct. 955,967 (1965)). Thus, the Review Board's decision in this case upholding Defendant's interpretation of Regulation 405.419 must be given a considerable, although not unlimited, degree of deference.

b. Defendant's interpretation of the regulations.

The Regents argues that for various reasons, the related party interest restrictions contained in Regulation 405.419 cannot be interpreted to act as an automatic bar to the recovery of interest expense owed by providers (i.e. its medical centers) to related entities (i.e. The Regents itself). Rather, it argues that the regulatory scheme should be interpreted to establish a rebuttable presumption that related party loans are improper. This presumption could be overcome, The Regents argues, by a showing that the particular loans at issue were in fact proper. Defendant argues, on the other hand, that the applicable regulatory language is unequivocal: related party interest expenses are not reimbursable.

Examination of an agency's interpretation of a regulation involves a two prong analysis. First, the words of a regulation must be "reasonably susceptible to the construction placed upon them by the Secretary, both on their face and in light of their prior interpretation and application." *Pacific Coast Medical*, 633 F.2d at 131. In this case, the applicable regulation, on its face, prohibits reimbursement of related party interest expenses.[5] Thus, Defendant's interpretation must prevail under this component of the analysis, since it is undisputed that The Regents and its medical providers are related entities.

Under the second component of the regulatory interpretation analysis, "the Secretary's construction must be reviewed in relation to the governing statute." *Id.* "Agency

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[5] Under the regulations, to be "proper," interest expense must be "paid to a lender not related through control or ownership, or personal relationship to the borrowing organization." 42 C.F.R. § 405.419(b)(3)(ii) (1985). In addition, in order "to be allowable, interest expense must be incurred on indebtedness established with lenders or lending organizations not related through control, ownership, or personal relationship to the borrower." *Id.* § 405.419(c).

regulations must be consistent with and in furtherance of the purposes and policies embodied in the congressional statutes which authorize them." *Id.* The statutory mandate applicable in this case requires only that providers be reimbursed for the "reasonable cost" of services they provide. 42 U.S.C. § 1395f(b). Moreover, the Secretary is specifically authorized by the Medicare statute to further define what constitutes "reasonable cost," and the items to be included in that definition. 42 U.S.C. § 1395x(v)(1)(A). Thus, for Defendant to deny reimbursement for related party borrowing seems entirely consistent with the statutory scheme Congress established for reimbursements under the Medicare program.

In spite of the result mandated by application of the Medicare regulations, however, The Regents argues that in its case, the related party interest restriction should not apply. the Regents bases its argument on several decisions by other courts that viewed Defendant's interpretation of Regulation 405.419 as inconsistent with the reimbursement mandate of the Medicare statute itself. *See Trustees of Indiana University v. United States*, 618 F.2d 736, 739 (Ct. Cl. 1980); *South Boston Gen. Hosp. v. Blue Cross*, 409 F. Supp. 1380, 1384-85 (W.D. Va. 1970). *Contra Hillside Community Hosp. v. Mathews*, 423 F. Supp. 1168, 1176 (N.D. Ca. 1976) (upholding Defendant's interpretation). In particular, The Regents cites the Court of Claims' decision in Indiana University for the proposition that a per se application of the related party interest exclusion in Regulation 405.419 is inconsistent with the purpose of the Medicare statute itself, that is, to reimburse providers for Medicare-related expenses. 618 F. 2d at 739; *see also South Boston*, 409 F. Supp. at 1384-85 (requiring Defendant to give individualized scrutiny to party borrowings). This inconsistency, the Court of Claims concluded, meant that it was not bound to follow the express wording of the regulation. *Indiana University*, 618 F.2d at 739 (citing *United States v. American Trucking Ass'ns, Inc.*, 310 U.S. 534, 543, 60 S. Ct. 1059, 1064 (1940) and *Rucker v.*

Wabash R.R. Co., 418 F.2d 146 (7th Cir. 1969)). In making its determination, however, the Court of Claims, made no mention of the deference it is required to give an agency's statutory interpretations.

Despite the holdings of other courts invalidating Defendant's interpretation of Regulation 405.419 based on its alleged inconsistency with the mandate of the Medicare statute, this Courts determination of the issue is governed by the Ninth Circuit's decision in *Goleta Valley Community Hospital v. Schweiker*, 647 F.2d 894 (9th Cir. 1981). In *Goleta Valley*, the Court stated:

> The [provider] argues that the application of [Regulations 405.427 and 405.419] automatically to deny reimbursement is contrary to both the Medicare Act and the United States Constitution. We have recently upheld both the statutory and constitutional validity of Regulation 405.427 by finding that the regulation is reasonably related to achieving a permissible objective. "The classification of 'related entity' . . . was established to prevent the reimbursement of excessive charges resulting from self-dealing . . . ." The related entity classification was a reasonable method of achieving this objective. *The same related entity classification is used in Regulation 405.419 for exactly the same purpose: to ensure that entities deal with each other at arm's length. Thus we find regulation 405.419 is also valid.*

Id. at 897 (quoting *American Hospital Management Corp. v. Harris*, 638 F.2d 1208, 1212, 1213 (9th Cir. 1981)) (citations omitted and emphasis added). Thus, Defendant's contention that the related party interest expense limitation *does* apply should prevail, despite the apparent over-inclusiveness of the regulation when applied to the facts of the present case. *See id.* (holding that under a comparable regulation, "[o]nce a de-

termination has been made that the organizations are related, the Board need not inquire into whether the reimbursements claimed were reasonable").

2. Defendant's Promulgation of the Regulation.

a. standard of review.

Finding the Secretary's interpretation of the applicable regulation to be proper, the Court must next address the issue of whether the regulation itself is a proper interpretation of the authorizing legislation. Review over an agency's exercise of its rule-making authority "is limited to determining whether the regulation is reasonably related to the purpose of the relevant enabling legislation, as well as to the more particular purpose through which the regulation implements those objectives in a particular area." *American Hospital*, 638 F.2d at 1212. Substantial deference must be given to the agency's interpretation of the enabling legislation. It is that agency which has been directed by Congress to interpret the statute, and presumably, in promulgating its regulations, it has used its particular expertise in the area to interpret that statute. *Id.*

b. promulgation of the regulation.

This Court's review of an agency's adoption of a regulation is limited to making a determination as to whether it is reasonably related to the purpose of the enabling legislation. *American Hospital*, 638 F.2d at 1212. In the present case, it is clear that the objective of Medicare reimbursement is "to approximate as closely as practicable the actual cost (both direct and indirect) of services the beneficiaries of the [medicare] program." S. Rep. No. 404, 89th Cong. 1st Sess. at 36 (1965), *reprinted in* 1965 U.S.C.C.A.N. 1943, 1976. This intent is reflected in the Medicare statute itself. 42 U.S.C. § 1395x(v)(1)(A) (mandating that both direct and indirect costs be taken into consideration by HHS when calculating Medicare reimbursement).

The Ninth Circuit's discussion of a Medicare regulation similar to that involved in this case is relevant to this court's

interpretation of Regulation 405.519. In *American Hospital*, the Ninth Circuit stated:

> The [Medicare] statute mandates that only costs actually incurred in the efficient delivery of needed health care services be reimbursed. The regulation implements that requirement by providing that where facilities, services or supplies are furnished to a provider by a "related" entity, the provider is to be reimbursed at the cost of those items to the related entity rather than at the cost charged to the provider. . . . The regulation is thus designed to prevent seemingly separate entities from engaging in what is in fact self-dealing at the expense of the Medicare program. . . . So long as the regulation has a reasonable basis in fact, the regulation must be upheld as a valid exercise of the Secretary's discretion.

638 F.2d at 1212. Unlike the regulation at issue in *American Hospital*, in the present case the applicable regulation denies The Regents *all* interest cost, not just that deemed over actual or market rates. The Regents uses this fact to argue that it should at least be entitled to recover related party interest expenses incurred at under-market rates. However, Defendant asserts that the justification for the related party interest regulation is not only a concern over excessive interest (comparable to the concern over excessive costs at issue in *American Hospital*). Rather, Defendant Asserts that its regulation preventing *any* reimbursement for related party interest expense is further justified by a concern that *unnecessary* loans will be made in the first place, in an attempt to recoup interest reimbursement from the Medicare program. Defendant's concern is that controlling entities such as The Regents will loan money to their related providers rather than make ordinary capital contributions in order to recover interest expenses from the Medicare program. This concern is entirely reasonable and this, will suffice as a basis for the Court to up-

hold the validity of Regulation 405.419. *See American Hospital*, 638 F.2d at 1212. Moreover, the reasonableness of the regulation is in line with Ninth Circuit's interpretations of related party reimbursement restrictions contained in other Medicare regulations. As the Court has stated:

> [I]n a program as complex and ripe with potential abuse as Medicare, the Secretary has broad discretion to control excessive costs by adopting general prophylactic rules which, despite their inherent imprecision, eliminate the need for a cumbersome and expensive process of adjudicating item-by-item the reasonableness of costs.

Marina Mercy Hosp. v. Harris, 633 F.2d 1301, 1304 (9th Cir. 1980); *see also American Hospital*, 638 F.2d at 1212; *Goleta Valley*, 647 F.2d at 897; *Wisconsin Dep't of Health & Human Servs. v. Bowen*, 797 F.2d 391, 399 (7th Cir. 1986) (holding that the over-inclusiveness of a regulation does not necessarily mean that it is arbitrary and capricious, so long as the agency has some "reasonable justification" for the rule). Thus, in this case, it is clear that Defendant's authority for promulgating rules is broad, and that such authority has not been exceeded by the adoption of Regulation 405.419.

B. Irrebuttable Presumption Disallowing Related Party Interest as Violative of Due Process.

Notwithstanding the reasonableness of Defendant's interpretation and promulgation of Regulation 405.419, The Regents asserts two constitutional grounds for its contention that Defendant's interpretation of that regulation is erroneous. In its first constitutional challenge, The Regents contests the constitutionality of Defendant's interpretation of Regulation 405.419 by claiming that it establishes an irrebuttable presumption violating the Due Process Clause of the Fifth Amendment. *See Vlandis v. Kline*, 412 U.S. 441, 447, 93 S. Ct. 2230, 2233 (1973) ("Statutes creating permanent irrebut-

table presumptions have long been disfavored under the Due Process Clause of the Fifth and Fourteenth Amendments.").

The Regents argument, however, must fail, again based on the Ninth Circuit's decision in *Goleta Valley*, 647 F.2d at 894. As discussed *supra*, in *Goleta Valley* the Ninth Circuit specifically held that Regulation 405.419's automatic denial of related party interest expense reimbursement was constitutionally valid. *Id.* at 897. This determination is consistent with the Supreme Court's directive that social welfare regulations need not be invalidated on due process grounds merely because they are not "made with mathematical nicety or because in practice [they] result [ ] in some inequity." *Dandridge v. Williams*, 397 U.S. 471, 485, 90 S. Ct. 1153, 1161 (1970). According to the Court, if there is some reasonable basis for the rule, it must be upheld. *Id.* Regulation 405.419 states its justification as "to assure that loans are legitimate and needed, and that the interest rate is reasonable." 42 C.F.R. § 405.419 (1985). "If the owner uses his own funds in a business, it is reasonable to treat the funds as invested funds or capital, rather than borrowed funds." *Id.* The Regents does not challenge the general reasonableness of this regulation, only the application of the regulation in this case. However, pursuant to the Supreme Court's decision in *Dandridge*, and the Ninth Circuit's holding in *Goleta Valley*, the Due Process challenge to the related party interest regulation must fail. *See also Hillside Community Hosp. v. Mathews*, 423 F. Supp 1168, 1176 (N.D. Cal. 1976) (rejecting a Medicare provider's argument that inflexible application of Regulation 405.419 amounts to an unconstitutional irrebuttable presumption).

C. First Amendment Violations.

The Regents' second constitutional challenge to Defendant's interpretation of Regulation 405.419 is based on the Establishment Clause of the First Amendment. In particular, The Regents cites a provision in Regulation 405.419 allowing reimbursement for related party interest expenses when "a provider operated by members of a religious order borrows

from the order." 42 C.F.R. § 405.419(c)(2) (1985). The Regents cites this provision to claim that if the regulation is interpreted categorically to disallow interest reimbursement for nonreligious related entities, then the exception allowing reimbursement for borrowing between related religious entities will violate the Establishment Clause of the First Amendment by giving such entities a preference over secular Medicare providers.

1. The Regents' Standing to Assert an Establishment Clause Challenge.

An initial question is raised as to The Regents standing to bring an Establishment Clause challenge to the religious order exception contained in Regulation 405.419.[6] One Court addressing the issue stated in *dicta*, that a provider similarly situated to The Regents "may lack the requisite standing to challenge the regulation in that [the fiscal intermediary] did not invoke Subsection (c)(2), the alleged unconstitutional subsection, when making adjustments to the [provider's] cost report." *Frankford Hospital v. Davis*, 647 F. Supp. 1443, 1452 (E.D. Pa. 1986). Although its motion fails to address the standing issue in any way, at oral argument on the present motions The Regents asserted that its standing to challenge the constitutionality of Regulation 405.419 was based on its position as a competitor of religiously affiliated Medicare providers. That is, since religiously affiliated competitors may recover related party interest expense and The Regents may not, those competitors are placed at an unfair advantage solely based on their religious affiliation. The Regents claims that this competitor advantage could cause it an economic injury sufficient to confer standing to challenge Defendant's interpretation of Regulation 405.419 under the Establishment Clause. A review of the doctrine of competitor standing, however, demonstrates that The Regents' argument must fail.

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[6] 42 C.F.R. § 419.405(c)(2) (1985) (redesignated 42 C.F.R. § 413.153 (c)(2) (1993)).

In order to invoke the doctrine of competitor standing, a party must "first allege that the challenged [regulatory] action has caused him injury in fact, economic or otherwise." *Association Of Data Processing Service Orgs., Inc. v. Camp*, 397 U.S. 150, 152, 90 S. Ct. 827, 829 (1970). In order for the reviewing court to find standing, "the plaintiff [must] show an injury to himself that is likely to be redressed by a favorable decision. Absent such a showing, exercise of its power by a federal court would be gratuitous and thus inconsistent with the Art. III limitation." *Simon v. Eastern Ky. Welfare Rights Org.*, 426 U.S. 26, 38, 96 S. Ct. 1917, 1924 (1976). When a party asserts only an indirect injury, it is substantially more difficult for a court to find standing created by that injury. *Id.* at 44-45, 96 S. Ct. at 1927; *see also City of Rohnert Park v. Harris*, 601 F.2d 1040, 1048 (9th Cir. 1979), *cert. denied*, 445 U.S. 961, 100 S. Ct. 1647 (1980).

In the present case, The Regents has not alleged that Defendant's invocation of the religious order exception in Regulation 405.419 has caused it any direct injury. Rather, The Regents makes only a vague, hypothetical assertion that the religious order exception could be invoked in such a manner by Defendant so as to cause it an economic injury. That injury would presumably relate to a loss of patients and revenue due to the higher prices The Regents would have to charge Medicare patients by not being reimbursed for related party borrowing expenses. Such attenuated and hypothetical injuries are an insufficient basis for this Court to find standing for The Regents to challenge Regulation 405.419 under the Establishment Clause. "Although potential injury may be sufficient to confer standing, the relationship between the injury here and the alleged illegal agency action is too attenuated to meet the minimum Article III requirements." *Rohnert Park*, 601 F.2d at 1049.

In order to find standing, the Court, without *any* evidence being presented by The Regents, would have to assume a number of elements in the causal chain between Defendant's

action and The Regents' asserted economic injury. These assumptions include: (1) that the religious order exception contained in Regulation 405.419 has been invoked by Defendant; (2) that religiously-affiliated Medicare providers gained some financial benefit from related party borrowing, and were allowed Medicare reimbursement from Defendant; (3) that such providers were competitors of The Regents; and (4) that being able to take advantage of the related party expense exception allowed such competitors to undercut The Regents in their provision of Medicare services, thus causing The Regents a competitive, economic injury. Without any evidence of such factors, the Court must find that The Regents assertions of possible economic injury are too conjectural and hypothetical to confer competitor standing. *See Rohnert Park*, 601 F.2d at 1049. Thus, having found that The Regents has no standing to challenge the religious order exception to related party interest reimbursement contained in Regulation 405.419, the merits of its Establishment Clause challenge need not be addressed by the Court.

V. CONCLUSION

Regulation 405.419 on its face denies The Regents reimbursement for interest expenses incurred through loans made to its related medical centers. This prophylactic regulation, while potentially over-inclusive in scope, has been reasonably interpreted by Defendant, and is itself a proper and reasonable interpretation of the Medicare statute. The constitutional challenges The Regents has made to the regulation must also fail. Agency regulation of social welfare programs such as the Medicare statute is given a broad degree of discretion and need not apply with any mathematical degree of precision in order to comply with the constitutional requirements of due process. While an Establishment Clause issue is raised by the religiously affiliated provider exception contained in Regulation 405.419, The Regents failure to illustrate how this exception caused it any sort of economic harm requires the

Court to find that The Regents has no standing to assert this challenge. Therefore, the Provider Reimbursement Review Board's determination on The Regents claims for reimbursement of related party interest expenses must be affirmed.

Finding no disputed issue of material fact in this matter, and that Defendant is entitled to judgment as a matter of law, the Court hereby GRANTS Defendant's Cross-Motion for Summary Judgment and Denies Plaintiff's Motion for Summary Judgment. Defendant's Statement of Uncontroverted Facts and Conclusions of Law is hereby incorporated into this Order.

IT IS SO ORDERED.

DATED: SEP 6 1994

/s/ RONALD S. W. LEW
RONALD S.W. LEW
United States District Judge

No. CV-93-4242-RSWL(Ex}, *The Regents of the University of California v. Donna Shalal, Secretary, United States Department of Health and Human Service*, Plaintiff's Motion for Summary Judgment, Defendant's Cross Motion for Summary Judgment.

APPENDIX C

[¶ 41,453] The Regents of the University of California—Working Capital Interest Expense Group Appeal.

PRRB Hearing Dec. No. 93-D41, May 14, 1993 (cost reporting periods ending-various). Case No. 86-0548G.

Before: MARTIN, SLOAN, PETTY-HANKINS, and ROARK.

MEDICARE: INTEREST EXPENSE PAID TO RELATED ORGANIZATION

Provider reimbursement—Allowable costs—Interest expense—Interest on loans from lenders related to the provider.—Interest expense is an allowable cost under Reg. Sec. 404.413 (redesignated 413.153) only if it is incurred on indebtedness established with lending organizations not related through control, ownership, or personal relationship to the borrower. The regulation provides exceptions for interest expenses on loans from a related organization if the loans are (1) between a provider's donor-restricted fund and its general fund, (2) to a provider's general fund from its funded depreciation account or qualified pension plan, or (3) from a related religious order. An intermediary properly disallowed the interest expenses and paid by a group of teaching hospitals to a related organization for working capital loans. The source of the loans was the related organization's short-term investment pool, which received its funds form a variety of sources. Further, the general rule for related parties in Reg. Sec. 405.427 (redesignated 413.17), which permits reimbursement of costs to a related organization if the costs are necessary and reasonable, cannot supersede the specific regulation dealing with interest expense.

See ¶ 5033.40, 5047, 5061.

[Test of Decision]

Issue:

Whether the Intermediary's adjustments disallowing interest expenses paid by the Providers to The Regents of the University of California, a related party, were proper.

Summary of Facts.

The Providers in this group appeal are general, acute care teaching hospitals which are licensed to and operated by The Regents of the University of California (The Regents). For the fiscal years in contention, the Intermediary made adjustments to the Providers' Medicare cost reports which denied interest expense claims on working capital loans made to the Providers by The Regents. The basis for the Intermediary's adjustments was that The Regents and the providers are related organizations and, therefore, the interest would not be allowable under the regulatory provisions of 42 C.F.R. § 405.419 [¶ 4900]. The Providers appealed the Intermediary's reimbursable cost determinations to the Provider Reimbursement Review Board (Board) under the provisions of 42 C.F.R. §§ 405.1835-1841 and have met the jurisdictional requirements of those regulations. The amount of Medicare reimbursement in dispute for all of the fiscal years in contention is approximately $1,600,000.

In the interest of expediting the administrative appeal process the parties entered into a Stipulation of Facts which included the following statements.

- The Regents operated the Providers pursuant to Article IX, section 9 of the California Constitution which provides in relevant part as follows:

The University of California shall constitute a public trust, to be administered by the existing corporation known as "The Regents of the University of California," will full powers of organization and government, subject only to such legislative control as may be necessary to insure the security of

its fund in compliance with the terms of the endowments of the University.

- Each of the Providers to this appeal cannot sue or be sued, enter into contracts or perform other legal functions in their own name. Each is precluded from borrowing monies from outside sources.

- During the fiscal years under appeal, the Providers received working capital loans from The Regents and paid an annual interest rate on the loans.

- For each of the fiscal years in contention, the annual interest rate on the working capital loans obtained by each of the Providers was lower than the applicable annual prime interest rate, and was also lower than the average rate earned by the University's short-term investment pool, from which the loan funds were borrowed.

- The short-term investment pool of the University receives cash from various sources including plant and loan funds, revenue bond funds, invested endowments, the University retirement system and others.

- As a result of severe fiscal problems by University hospitals during the 1976-1977 fiscal year, the Legislature of the State of California appropriated a $25 million fund entitled "University of California Teaching Hospital Revolving Fund." This fund was to be used for the University hospitals' working capital requirements along with other funds of the University.. Due to a state budget crisis, the $25 million working capital fund was withdrawn from the University during the 1980—1981 fiscal year.

- Because of the State of California's withdrawal of financial operating support, the University hospitals had to find alternative means of providing for working capital needs. On January 22, 1981, a new policy of charging interest on working capital was implemented, and

this official policy is reflected in the University of California's accounting manual.

Provider's Contentions:

The Providers contend that the regulation should be construed to permit the allowance of interest expense on reasonable, proper and necessary loans between related parties. In support of their position, the Providers present the following analysis of the regulation which states in pertinent part the following:

> (a)(1) *Principle.* Necessary and proper interest on both current and capital indebtedness is an allowable cost.
>
> . . . .
>
> (b)(2) *Necessary.* Necessary requires that the interest.
>
> (i) Be incurred on a loan made to satisfy a financial need of the provider. Loans which result in excess funds or investments would not be considered necessary.
>
> Be incurred on a loan made for a purpose reasonably related to patient care.
>
> (i) Be incurred at a rate not in excess of what a prudent borrower would have had to pay in the money market existing at the time the loan was made.
>
> (ii) Be paid to a lender not related through control or ownership, or personal relationship to the borrowing organization. However, interest is allowable if paid on loans from the provider's donor-restricted funds, the funded depreciation account, or provider's qualified pension funds.
>
> (b)(3) Proper. Proper requires that interest:
>
> (c) *Borrower-lender Relationship.*
>
> (1) To be allowable, interest expense must be incurred on indebtedness established with lenders or lending organi-

zations not related through, control, ownership, or personal relationship to the borrower. Presence of any of these factors could affect the "bargaining" process that usually accompanies the making of a loan, and could thus be suggestive of an agreement on higher rates of interest or of unnecessary loans. Loans should be made under terms and conditions that a prudent borrower would make in arms-length transaction with lending institutions. *The intent of this provision is to assure that loans are legitimate and needed, and that the interest rate is reasonable.* Thus, interest paid by the provider to partners, stockholders, or related organizations of the provider would not be allowable. Where the owner uses his own funds in a business, it is reasonable to treat the funds as invested funds or capital, rather than borrowed funds. Therefore, where interest on loans by partners, stockholders, or related organizations is disallowed as a cost solely because of the relationship factor, the principal of such loans shall be treated as invested funds in the computation of the provider's equity capital under § 405.429.

(2) Exceptions to the general rule regarding interest on loans from controlled sources of funds are made in the following circumstances. Interest on loans to providers by partners, stockholders, or related organizations made prior to July 1, 1996, is allowable as cost, provided that the terms and conditions of payment of such loans have maintained in effect without modification subsequent to July 1, 1966. Where the general fund of a provider "borrows" from a donor restricted fund and pays interest to the restricted fund, this interest expense is allowable cost. The same treatment is accorded interest paid by the general fund on money "borrowed" from the funded depreciation account of the provider or from the provider's qualified pension fund. *In addition, if a provider operated by members of a religious order borrows from the*

order, interest paid to the order is an allowable cost (emphasis added).

42 C.F.R. § 405.419 [¶4900]

The Providers contend that the clear intent of the above regulations is to assure that loans are legitimate and needed and that the interest rate is reasonable. With respect to loans between related organizations, the purpose of the regulation is to prevent proprietary owners of the provider from inimically capitalizing the entity, advancing funds in the form of loans rather than capital and, thus, permitting the owners to be repaid while receiving the benefits of interest income charged through the controlled relationship of the provider. The disallowance of such interest expense to proprietary owners is compensated by treating the loans as investment funds in the computation of a proprietary provider's return on equity capital. In this case, the Providers point out that they are not proprietary entities and, thus, the treatment of working capital loans as investment in equity is not an available alternative.

In addition to the interest expense regulations at 42 C.F.R. § 405.419, the regulations at 42 C.F.R. § 405.427 [¶5675] define costs to a related organization and permit the reimbursement of such costs if the expense is necessary and reasonable. The providers contend that reconciliation of these two regulations compels the conclusion that each transaction between related organizations must be reviewed in light of the abuse the regulations are designed to prevent, and that prophylactic application of the regulations was never intended and is unwarranted. The prophylactic application of the regulations make the operation of 42 C.F.R. § 405.419 far harsher in result than 42 C.F.R. § 405.427. The Providers believe that permitting necessary and reasonable interest expense between related organization will result in the prohibition of unnecessary inflated costs to the Medicare program or the incurrence of unnecessary loans at inflated interest rates.

In support of their position, the providers cite the Court of Claims decision in *The Trustees of Indiana University v. U.S.*, U.S. Court of Claims, No. 71-78, dated March 19, 1980 [1980 Transfer Binder ¶ 30,398]. The providers state that their case is very similar to the *Indiana University* case in that, except for clinical teaching support, the hospitals received no operating funds from the state. In addition, they were not able to borrow outside the University to meet operational requirements since they were not separate legal entities. In permitting reimbursement of interest paid to the Trustees of Indiana University by its teaching hospitals, the court held as follows:

> Moreover, a regulation must be interpreted so as to harmonize with and further and not to conflict with the objective of the statute it implements. *See, e.g. Clark v. United States*, 220 Ct.Cl. — 599 F.2d 411 (1979); *Farrell Lines, Inc. v. United States*, 204 Ct. Co. 482, 499 F.2d 587 (1974).
>
> In light of these principles, we conclude that the regulation does not bar reimbursement for the interest the hospitals paid to *Indiana University*. As the regulation itself indicates, its purpose is to protect the government against paying the cost of collusive loans with inflated interest rates that are designed to benefit enterprises associated with providers of Medicare services. The relationships the regulations describes indicate the evils against which the ban is directed; (1) persons or an organization who control the hospital (e.g., a member of the board of directors or manager); (2) persons or an organization who own the hospital (*e.g.*, a commercial venture which runs a proprietary hospital); (3) persons who have a personal relationship with the hospital (*e.g.*, a staff doctor). In each of these instances, the other party, because of its own interest, may unduly influence the hospital's decision to the prejudice of the government if the latter reimburses the hospital for the interest payments.

> None of these evils is present in the loan between Indiana University and Indiana University Hospitals. Neither party had a profit motive. To the contrary, Indiana University could have received a greater return on its money by investing it elsewhere. The charged interest, moreover, was far below the market rate, and the loans were made because the University was the sole source the hospitals could turn to for operating capital. . . .
>
> The Medicare statute requires reimbursement for the "reasonable costs" of the services provided, and the regulation recognizes that "[n]ecessary and proper interest . . . is an allowable cost." There is nothing to indicate or even suggest that the interest the hospitals paid to the University, which was below the going rate and was paid to the only sources from which the hospitals could borrow, was either unnecessary or improper. In light of the purposes of the statute and the regulations as a whole to reimburse providers of Medicare services for their reasonable costs in providing those services, we conclude that the plaintiffs are entitled to reimbursement of the portions of the interest the hospitals paid to the University in 1970 and 1971 that are attributable to the provision of Medicare services.

In addition to the *Indiana University* decision, the Providers also cite the court decision in *Northwest Hospital, Inc. v. Hospital Service Corp., Blue Cross Association*, U.S. Court of Appeals, Seventh Circuit, No. 83-3038, dated March 14, 1984 [1982 Transfer Binder ¶32,113]. In the *Northwest Hospital* decision, the court also permitted an exception to the regulatory prohibition of interest paid to a related party as required under 42 C.F.R. § 405.419 stating the following:

> Although we do not question, as a general matter, an agency's authority to adopt prophylactic regulations reasonably designed to combat potential abuse or to avoid the difficulty of multiple individual determina-

> tions, we believe that the blanket disallowance of related-party interest expense contained in section 405.419(c) is broader than either the language or the purpose of the Medicare statute can be construed to authorize.
>
> . . . .
>
> Section 405.427 does not prohibit reimbursement for the reasonable costs of materials and services obtained from related-party suppliers; it merely establishes a rebuttable limitation on cost which will be deemed reasonable (and hence reimbursed). Section 405.419, by contrast, precludes reimbursements for all interest payments made on related-party loans, regardless of their reasonableness, and despite the Secretary's explicit acknowledgment that necessary and proper interest on both current and capital indebtedness is an allowable cost.

The Providers contend that the Medicare statute directs the Secretary of health and Human Services to implement the program by reimbursing providers the lesser of "reasonable cost for covered services or customary charges associated with those services" (42 U.S.C. § 1395f(b)(1) [¶ 16,588]). Reasonable cost is defined as being the actual cost less any portion "unnecessary in the efficient delivery of needed health care services" (42 U.S.C. § 1395x(b)(1)(A) [¶16,954]). Interest expense is determined to be a reasonable cost (42 C.F.R. § 405. 402(c) [¶20,887.5]). A basic principle of the Medicare program is that costs of caring for Medicare patients not be borne by individuals not covered by the Social Security Act. Thus, if the loans were necessary, reasonably related to patient care and proper, the Providers argue that they would not be able to charge the Medicare program for their fair share of interest expense by application of a prophylactic interpretation of the regulation in 42 C.F.R. § 405.419. This would result in the Medicare program's share of interest cost being passed on to non-Medicare patients contrary to statutory and regulatory requirements.

Regarding the provision in 42 C.F.R. § 405.419(c)(2) which permits a provider operated by a religious order to borrow from the order and claim the interest paid as allowable costs, the Providers believe that this regulatory condition demonstrates that they are not being treated equally when compared to hospitals run by religious organizations. They point out that this provision is a recognition that hospitals operated by religious orders do not have a proprietary or commercial motive and that borrowing within religious orders should not be treated the same as borrowing within proprietary organizations. The Providers note that their relationship to The Regents is precisely the same as that of a religious hospital and its mother organization. Thus, to treat them differently than a religious hospital on borrowings of working capital from its parent organization would deny them equal protection in violation of the First Amendment to the United States Constitution.

Intermediary's Contentions

The Intermediary contends that its disallowance of interest expense claimed by the Providers was properly based on the application of 42 C.F.R. § 405.419 which states in part that, for interest expense to be allowable, it must:

> (b)(3)(iii) Be paid to a lender not related through control or ownership, or personal relationship to the borrowing organization.
>
> . . . .
>
> (c) Borrower-lender relationship. (1) Except as described in paragraph (c) (2) of this section, to be allowable, interest expense must be incurred on indebtedness established with lenders or lending organizations not related through control, ownership, or personal relationship to the borrower . . . . Thus, interest paid by the provider to partners, stockholders, or related organizations of the provider, would not be allowable.

The Intermediary does not question the legitimacy, necessity or interest rates on the loans. The Intermediary also realizes that the Providers are not proprietary organizations and are not entitled to a return on equity capital. However, the Intermediary states that the regulation is clear and that it has no choice but to enforce its application in this case.

The Intermediary also acknowledge the Providers' citation of the court decision in *Indiana University* which is similar to the case at hand. However, the Intermediary notes that it does not have the authority to circumvent existing regulations, nor does it view that decision as precedent setting at this point in the administrative process. By contrast, the Intermediary refers to the court decision in *University of Cincinnati, d/b/a/ Cincinnati General Hospital v. Heckler*, U.S. Court of Appeals, Sixth Circuit, No. 83-3078, May 14, 1984, [1984-2 Transfer Binder ¶ 33,969] wherein the court supports its position and counters the Indiana University decision.

Based on the Stipulation of Facts entered into by the parties, there is no dispute that The Regents and the Providers are related parties, and that the loans do not meet any of the exceptions to the general rule regarding interest on loans from controlled sources of funds. Accordingly, the Intermediary believes its adjustments should be affirmed based on its proper application of 42 C.F.R. § 405.419.

Citation of Law and Regulations:

1. *Law—Title XVIII of the Social Security Act:*

§ 1861(v)(1)(A)—Reasonable Cost ..... [¶ 16,974]

2. Regulations—42 C.F.R.:

§ 405.402 (Redesignated § 413.5)—Cost Reimbursement; General ..... [¶ 20,887.5]

§ 405.419 (Redesignated § 413.153)—Interest Expense ..... [¶ 4900]

§ 405.427 (Redesignated § 413.17)—Cost to Related Organizations ..... [¶ 5675]

§ 405.429 (Redesignated § 413.157)—Return on Equity Capital of Proprietary Providers ..... [¶ 5750]

Findings and Conclusions:

the Board, after consideration of the facts, parties' contentions and evidence presented finds and concludes that the Intermediary properly disallowed the interest expense paid by the Providers to The Regents, the related parent organization, consistent with the regulatory requirements of 42 C.F.R. § 405.419. The Board is bound by Medicare law and regulations. The treatment of interest expense incurred on borrowings from a related party is specifically addressed in the regulation at 42 C.F.R. § 405.419 (c) which states in part:

> Borrower-lender relationship. (1) Except as described in paragraph (c)(2) of this section, to be allowable, *interest expense must be incurred on indebtedness established with lenders or lending organizations not related through control, ownership, or personal relationship to the borrower* (emphasis added).

Since the parties in this case have stipulated that the Providers and The Regents are related under Medicare regulation 42 C.F.R. § 405.427, the Board finds that the above-stated regulation clearly denies the interest expense paid by the Providers to their related parent organization.

The Board also considered the specific circumstances under 42 C.F.R. § 405.419(c)(2) which provide exceptions to the general rule regarding interest expense on loans from controlled sources. This regulatory provision treats interest expense on related-organization loans as an allowable cost under the following four situations:

> (1) Pre-July 1, 1996 loans from partners, stockholders, or related organizations;

(2) Loans between a provider's donor-restricted fund and its general fund;

(3) Loans to a provider's general fund from its funded depreciation account or qualified pension plan; and

(4) Loans from a related religious order.

Since the source of the funds borrowed by the Providers was the University's short-term investment pool which receives its funds from a variety of sources, the Providers clearly did not meet any of the specific exceptions of the regulation. The Board finds the above list to be all-inclusive and that the regulation does not permit additional exceptions such as the loans existing between the Providers and The Regents in this case.

With regard to the Providers' argument that there is a conflict between the purpose of the related party regulation (42 C.F.R. § 405.427) and the portion of the interest expense regulation that deals with related parties (42 C.F.R. § 405.419(c)(1) and (2)), the Board does not concur. The above interest regulation which deals with related party borrowing is the Medicare program's specific regulation controlling this specific type of cost. The general rule for related parties in 42 C.F.R. §405.427 cannot be used to supersede the specific regulation dealing with a specific type of expense, which is interest expense in this case.

The board is also cognizant of the Providers' argument that one of the regulatory exceptions under 42 C.F.R. § 405.4219(c)(2) permits interest on loans between a religious hospital and its related mother organization, and that such discriminatory action denies the equal protection in violation of the First Amendment of the United States Constitution. Pursuant to 42 C.F.R. § 405.1867 [¶20,767] the Board "must comply with all the provisions of title XVIII of the Act and regulations issued thereunder . . . ." Consequently, the

Board is not the proper forum in which to present a constitutionally based challenge to the regulation.

As to the Provider's reliance on the court decisions in *Indiana University and Northwest Hospital*, the Board recognizes that the regulations were, in fact, circumvented by the courts on the basis that none of the evils which the regulation sought to prohibit existed in those cases. Notwithstanding the specific points addressed in the court decisions, the Board is obligated to adhere to the provisions of Title XVIII of the Social Security Act, as amended, and 42 C.F.R. § 405.1867.

Decision:

The Intermediary's adjustments disallowing interest expense paid by the Providers to The Regents of the University of California, a related party, were proper. The Intermediary's adjustments are affirmed.

[Exhibit omitted.]

APPENDIX D

DEPARTMENT OF HEALTH & HUMAN SERVICES

Health Care Financing Administration
6325 Security Boulevard
Baltimore, MD 21207

RECEIVED: JUL 1, 1993

Robert Barnes, Esq.
University of California
300 Lakeside Drive, 7th Floor
Oakland, California 94612-3565

Dear Mr. Barnes:

Re: *The Regents of the University of California*, PRRB No. 93-D41 (FYE) Various)

This is to advise that the Administrator of the Health Care Financing Administration (HCFA) has declined to review the decision entered by the Provider Reimbursement Review Board in the captioned case.

If the Provider wishes to obtain judicial review of the matter, civil action must be initiated within 60 days of the date the Board's decision was received in accordance with 42 C.F.R. 405.1877.

Sincerely yours,
/s/ Marion T. Silva
Marion T. Silva
Attorney Advisor

Enclosure

cc: Bernard M. Talbert, Esq., Intermediary's Representative

DEPARTMENT OF HEALTH & HUMAN SERVICES

Health Care Financing Administration
6325 Security Boulevard
Baltimore, MD 21207

Re: *The Regents of the University of California*,
PRRB Decision No. 93-D41 (05/14/93)
(FYEs Various

I recommend that the Administrator, Health Care Financing Administration, on own motion, decline to review the decision entered by the Provider Reimbursement Review Board in this case.

Sincerely yours,
/s/ Marion T. Silva
Marion T. Silva
Attorney Advisor

APPROVED:
/s/ Louis B. Hays
Acting Executive Associate
Administrator
Health Care Financing
Administrator

Date: 6/25/93

APPENDIX E

REGULATORY PROVISION INVOLVED

§ 413.153 Interest expense.

(a)(1) *Principle.* Necessary and proper interest on both current and capital is an allowable cost. However, interest costs are not allowable if incurred as a result of—

(i) Judicial review by a Federal court (as described in § 413.64(j));

(ii) An interest assessment on a determined overpayment (as described in § 405.376 of this chapter); or

(iii) Interest on funds borrowed to repay an overpayment (as described in § 413.64(j) or § 405.376 of this chapter), up to the amount of the overpayment, unless the provider had made a prior commitment to borrow funds for other purposes (for example, capital improvements).

(2) *Exception.* In those cases of administrative or judicial reversal, interest paid on funds borrowed to repay an overpayment is an allowable cost, in accordance with this section.

(b) *Definitions* - (1) *Interest.* Interest is the cost incurred for the use of borrowed funds. Interest on current indebtedness is the cost incurred for funds borrowed for a relatively short term. This is usually for such purposes as working capital for normal operating expenses. Interest on capital indebtedness is the cost incurred for funds borrowed for capital purposes, such as acquisition of facilities and equipment, and capital improvements. Generally, loans for capital purposes are long-term loans.

(2) *Necessary.* Necessary requires that the interest be—

(i) Incurred on a loan made to satisfy a financial need of the provider. Loans that result in excess funds or investments would not be considered necessary;

(ii) Incurred on a loan made for a purpose reasonably related to patient care; and

(iii) Reduced by investment income except if such income is from gifts and grants, whether restricted or unrestricted and that are held separate and not commingled with other funds. Income from funded depreciation that meets the requirements of § 413.134 or a provider's qualified pension fund is not used to reduce interest expense. Interest received as a result of judicial review by a Federal Court (as described in § 413.64(j)) is not used to reduce interest expenses.

(3) *Proper.* Proper requires that interest be—

(i) Incurred at a rate not in excess of what a prudent borrower would have had to pay in the money market existing at the time the loan was made; and

(ii) Paid to a lender not related through control or ownership, or personal relationship to the borrowing organization. However, interest is allowable if paid on loans form the provider's doner-restricted funds, the funded depreciation account, or the provider's qualified pension fund.

(c) *Borrower-lender relationship*, (1) Except as described in paragraph (c)(2) of this section, to be allowable, interest expense must be incurred on indebtedness established with lenders or lending organizations not related through control, ownership, or personal relationship to the borrower. Presence of any of these factors could affect the "bargaining" process that usually accompanies the making of a loan, and could thus be suggestive of an agreement on higher rates of interest or of unnecessary loans. Loans should be made under terms and conditions that a prudent borrower would make in armslength transactions with lending institutions. The intent of this provision is to assure that loans are legitimate and needed, and that the interest rate is reasonable. Thus, interest paid by the provider to partners, stockholders, or related organizations of the provider would not be allowable. If the owner uses his own funds in a business, it is reasonable to

treat the funds are invested funds or capital, rather than borrowed funds. Therefore, if interest on loans by partners, stockholders, or related organizations is disallowed as a cost solely because of the relationship factor, the principal of such loans is treated as invested funds in the computation of the provider's equity capital under § 413.157.

(2) Exceptions to the general rule regarding interest on loans from controlled sources of funds are made in the following circumstances. Interest on loans to providers by partners, stockholders, or related organizations made prior to July 1, 1966, is allowable as cost, provided that the terms and conditions of payment of such loans have been maintained in effect without modification subsequently to July 1, 1966. If the general fund of a provider "borrows" from a donor-restricted fund and pays interest to the restricted fund, this interest expense is an allowable costs. The same treatment is accorded interest paid by the general fund on money "borrowed" from the funded depreciation account of the provider or from the provider's qualified pension fund. In addition, if a provider operated by members of a religious order borrows from the order, interest paid to the order is an allowable cost.

(3) If funded depreciation is used for purposes other than improvement, replacement, or expansion of facilities or equipment related to patient care, allowable interest expense is reduced to adjust for offsets not made in prior years for earnings on funded depreciation. A similar treatment is accorded deposits in the provider's qualified pension fund if such deposits are used for other than the purpose for which the fund was established.

(d) *Loans not reasonably related to patient care.* (1) The following types of loans are not considered to be for a purpose reasonably related to patient care:

(1) For loans made to finance acquisition of a facility, that portion of the cost that exceeds—

(A) Historical cost as determined under § 413.134(b); or

(B) The cost basis determined under §413.134(g); and

(ii) Loans made to finance capital stock acquisitions, mergers, or consolidations for which revaluation of assets is not allowed under § 413.134(k).

(2) In determining whether a loan was made for the purpose of acquiring a facility, we apply any owner's investment or funds first to the tangible assets, than to the intangible assets other than goodwill, and lastly to the goodwill. If the owner's investment or funds are not sufficient to cover the cost allowed for tangible assets, we apply funds borrowed to finance the acquisition to the portion of the allowed cost of the tangible assets not covered by the owner's investment, then to the intangible assets other than goodwill, and lastly to the goodwill. Repayments of the funds borrowed are applied first to the borrowing related to the tangible assets, then to the borrowing related to the intangible assets other than goodwill, and lastly to the borrowing related to the goodwill.

(3) When a provider borrows funds but only some of the funds are necessary, repayments of the loan (principal and interest portions) are applied first to pay for the necessary portion of the loan. Only after all of the necessary portion of the loan (principal and interest) has been repaid are any repayments applied to the unnecessary portion of the loan. Repayments toward non-allowable borrowing pertaining to assets or activities not related to patient care are considered investments, and the provisions of paragraph(b)(2)(iii) of this section are applied.

(e) *Limitation on Federal participation for capital expenditures.* The allowance for depreciation is not an allowable cost for certain capital expenditures as described in § 413.161.

[51 FR 34793, Sept. 30, 1986, as amended at 56 FR 43457, Aug. 30, 1991; 59 FR 45402, Sept. 1, 1994]

APPENDIX F

STATUTORY PROVISION INVOLVED

42 U.S.C. Section 1395x(v)(1)(A)

(v) Reasonable costs

(1)(A) The reasonable cost of any services shall be the cost actually incurred, excluding therefrom any part of incurred cost found to be unnecessary in the efficient delivery of needed health services, and shall be determined in accordance with regulations establishing the method or methods to be used, and the items to be included, in determining such costs for various types or classes of institutions, agencies, and services; except that in any case to which paragraph (2) or (3) applies, the amount of the payment determined under such paragraph with respect to the services involved shall be considered the reasonable cost of such services. In prescribing the regulations referred to in the preceding sentence, the Secretary shall consider, among other things, the principles generally applied by national organization or established prepayment organizations (which have developed such principles) in computing the amount of payment, to be made by persons other than the recipient of services, to providers of services on account of services furnished to such recipients by such providers. Such regulations may provide for determination of the costs of services on a per diem, per unit, per capita, or other basis, may provide for using different methods in different circumstances, may provide for the establishment of limits on the direct or indirect overall incurred costs or incurred costs of specific items or services or groups of items or services to be recognized as reasonable based on estimates of the costs necessary in the efficient delivery of needed health services to individuals covered by the insurance programs established under this subchapter, and may provide for the use of charges or a percentage of charges where this method reasonably reflects the costs. Such regulations shall (i) take into account

both direct and indirect costs of providers of services (excluding therefrom any such costs, including standby cost, which are determined in accordance with regulations to be unnecessary in the efficient delivery of services covered by the insurance programs established under this subchapter) in order that, under the methods of determining costs, the necessary costs of efficiently delivering covered services to individuals covered by the insurance programs established by this subchapter will not be borne by individuals not so covered, and the costs with respect to individuals not so covered will be borne by such insurance programs, and (ii) provide for the making of suitable retroactive corrective adjustments where, for a provider of services for any fiscal period, the aggregate reimbursement produced by the methods of determining costs proves to be either inadequate or excessive.

APPENDIX G

THE TRUSTEES OF INDIANA UNIVERSITY
(Indiana University Hospitals)

v.

THE UNITED STATES.

No. 71-78.

United States Court of Claims.

March 19, 1980.

Indiana University Hospitals brought an action claiming its entitlement to reimbursement under the Medicare Act for interest which it paid to Indiana University on money borrowed from it. Upon hospitals' motion for summary judgment and the government's cross motion for summary judgment, the Court of Claims, Friedman, C.J., held that in light of facts that hospitals were teaching hospitals, received no money from state for their operation and could not borrow money from outside University because they were not separate legal entity, regulation limiting reimbursement of interest to amount paid to nonrelated persons did not bar hospitals' claim for reimbursement.

Hospitals' motion for summary granted; Government's motion for summary judgment denied; case remanded.

Kunzig, J., filed concurring opinion.

TRUSTEES OF INDIANA UNIVERSITY

v.

UNITED STATES

Cite as 618 F.2d 736 (1980)

1. Administrative Law and Procedure
412
Statutes 189

Where "plain meaning" of a statute produces an unreasonable result plainly at variance with policy of legislation as a whole, courts may follows that purpose rather than the literal words; foregoing principles are also applicable in construing administrative regulations.

2. Administrative Law and Procedure
412

A regulation must be interpreted so as to harmonize with and further and not to conflict with objective of statute it implements.

3. Social Security and Public Welfare
241.10

In light of facts that Indiana University Hospitals were teaching hospitals, received no money from state for their operation and could not borrow money from outside University because they were not a separate legal entity, regulation limiting reimbursement of interest to amount paid to nonrelated persons did not bar hospitals' claim for reimbursement under Medicare Act for interest which they paid to University on money borrowed from it. Social Security Act, § 1861(v)(1)(A), 42 U.S.C.A. § 1395x (v)(1)(A).

4. Constitutional Law 48(3)

Statute should be construed so as to avoid any serious doubts concerning its constitutionality.

William S. Hall, Indianapolis, Ind., attorney of record, for plaintiffs. Hall, Render & William, Indianapolis, Ind., of counsel.

John W. Showalter, Washington, D.C. with whom was Asst. Atty. Gen. Alice Daniel, Washington, D.C. for defendant. Sanford Teplitsky, Dept. of H.E.W., Washington, D.C., of counsel.

Before FRIEDMAN, Chief Judge, COWEN, Senior Judge, and KUNZIG, Judge.

ON PLAINTIFFS' MOTION FOR SUMMARY JUDGMENT AND DEFENDANT'S CORSS-MOTION FOR SUMMARY JUDGMENT.

FRIEDMAN, Chief Judge:

The question in this case is whether the Indiana University Hospitals are entitled to reimbursement under the Medicare Act (42 U.S.C. § 1395x(v)(1)(A) (1976) for the interest the hospitals paid to Indiana University on money they borrowed from it. The Blue Cross Association, which the hospitals selected as their fiscal intermediary to determine the amount of reimbursement to which they are entitled under the Medicare statute, denied reimbursement on the ground that a Medicare regulation limits reimbursement of interest to amounts paid to nonrelated persons. Both parties have moved for summary judgment, and we heard oral argument. We conclude that the plaintiffs are entitled to reimbursement for the interest. Therefore we deny the defendant's and grant the plaintiffs' motion for summary judgment.

I.

The plaintiffs, the Trustees of Indiana University, operate Indiana University, a State university. Indiana University Hospitals are a part of the University and its Medical Center.

The hospitals provide services to low-income patients under the Medicare Act, and, under the Act, as a "provider" of those services, are entitled to reimbursement for their reasonable costs of doing so.

The relationship of the hospitals to the University and to the State of Indiana is unique. They are state teaching hospitals, but received no money from the State for their operations. Although the State of Indiana Provides funds for the University, State law prohibits funds for the University, State law prohibits the use of any of those funds for the hospital. Since the hospitals are not a separate legal entity, they cannot borrow money from outside the University. If the hospitals cannot support themselves through the fees they collect, they must borrow from the University itself.

Beginning in 1968, the hospitals borrowed money from the University's general fund to compensate for their operating losses. The University charged 5 percent annual interest, which it subsequently increased to 6 percent; the interest rate consistently has been below the prime rate.

The hospitals paid the University interest of $221,488 for the fiscal year ending June 30, 1970, and $317,005 for the fiscal year ending June 30, 1971. The portions of those interest payment's attributable to the hospitals' provision of Medicare services were $24,054 and $37,59, respectively. The University sought reimbursement for this interest, but the Blue Cross Association denied it. The University then filed in the United States District Court for the Southern District Court for the Southern District of Indiana the present suit to recover those amounts. The district court transferred the case to this court pursuant to 28 U.S.C. § 1406(c) (1976).

II.

A. The Medicare program was established pursuant to subchapter XVIII of the Social Security Act, 42 U.S.C. § 1395 et seq. (1976), to provide health insurance for the aged and disable. Under the program, hospitals are certified to treat

eligible patients and reimbursed for the "reasonable costs" of the services provided. *Id.* § 1395(b)(1). Section 1395x(v)(1)(A) defines what is reimbursable for the and authorizes the Secretary of health, Education, and Welfare to promulgate regulations governing the procedures and the standards for making that determination:

> The reasonable cost of any services shall be the cost actually incurred, excluding therefrom any part of incurred cost found to be unnecessary in the efficient delivery of needed health services, and shall be determined in accordance with regulations establishing the method or methods to be used, and the items to be included, in determining such costs for various types or classes of institutions, agencies, and services . . . Such regulations shall (I) take into account both direct and indirect cost of providers of services . . . in order that, under the methods of determining costs, the necessary costs of efficiently delivering covered services to individuals covered by the insurance programs established by this subchapter will not be borne by individuals not so covered, and the costs with respect to individuals not so covered will not be borne by such insurance programs, and (ii) provide for the making of suitable retroactive corrective adjustments where, for a provider of services for any fiscal period, the aggregate reimbursement produced by the methods of determining costs proves to be either inadequate or excessive.

The Secretary has promulgated regulations specifying the costs that are reimbursable. Principles of Reimbursement for Provider Cost and for Service by Hospital Based Physician, 42 C.F.R. § 405.401 *et. seq.* (1979). "[T]he principles give recognition to such factors as depreciation, interest, bad debts, educational costs, compensation of owners, and an al-

lowance for a reasonable return on equity capital of proprietary facilities." *Id.* § 405.405 (c).

Section 405.419(a) provides: "Necessary and proper interest on both current and capital indebtedness is an allowable cost." Section 405.419(b)(3)(ii) states that to be "proper" interest, the money must "[b]e paid to a lender not related through control or ownership, or personal relationship to the borrowing organization."

The regulation then explains the reason for and scope of the prohibition against reimbursement for loans between related parties:

> Presence of any these factors could affect the "bargaining process [that] usually accompanies the making of a loan, and could thus be suggestive of an agreement on higher rates of interest or of unnecessary loans. Loans should be made under terms and conditions that a prudent borrower would make in arms length transactions with lending institutions. The intent of this provision is to assure that loans are legitimate and needed, and that the interest rate is reasonable. Thus, interest paid by the provider to partner, stockholders, or related organizations of the provider would not be allowable.

Id. § 405.419(c)(1)

The regulation provides three exceptions, which do not touch on the issues in this case. It also provides that if a provider "operated by members of a religious order borrows from the order, interest paid to the order is an allowable cost." *Id.* § 405. 419(c)(2).

There have been three district court cases challenging the ban on reimbursement of interest to related persons; two

courts have upheld the regulation, and one has invalidated it.[1] Although the parties vigorously argue the validity of the regulation, we find it unnecessary to reach that issue because we construe the regulation as not prohibiting reimbursement for the interest payments here allowed.

[1, 2] B. Read literally and without regard to the other provisions or the purpose of the regulation and to the underlying statute (as the defendant would have us read it), the bar on reimbursement for payments to related organizations would appear to cover this case. The lender here, Indiana University, is "related through control or ownership . . . to the borrowing organization [the hospitals]." "It is [, however,] a 'familiar rule, that a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers.' ". *United Steelworkers of America v. Weber,* 443 U.S. 193, 99 S.Ct. 2721, 2727, 61 L.Ed.2d 480 (1979) (quoting *Church of Holy Trinity v. United States,* 143 U.S. 457, 459, 12 S.Ct. 511, 512, 36 L.Ed. 226 (1892)). Indeed, if the "plain meaning" of a statute produces an "unreasonable" result " 'plainly at variance with the policy of the legislation as a whole' " the courts have "followed that purposes, rather than the literal words." *United States v. American Trucking Associations, Inc.* 310 U.S. 534, 543, 60 S.Ct. 1059, 1064, 84 L.Ed. 1345 (1940). These principles are no less applicable in constructing administrative regulations. *Rucker v. Wabash Railroad Co.*, 418 F.2d 146 (7th Cir. 1969). Moreover, a regulation must be interpreted so as to harmonize

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[1] *Caylor-Nickel Hosp. v. Califano,* No. F77-83 (N.D.Ind. Sept. 10, 1979) (regulation constitutional; loans from doctors who managed the hospital and from associated clinic); *Hillside Community Hosp. v. Mathews,* 423 F.Supp. 1168 (N.D. Cal. 1976) (regulation constitutional; payment for purchase of building from company owned in part by members of hospital board of directors); *South Boston Gen. Hosp. v. Blue Cross,* 409 F.Supp.1380 (W.D.Va.1976)(regulation invalid as contrary to purpose of Act to reimburse for reasonable costs; loan on purchase of building from predecessor hospital).

with and further and not to conflict with the objective of the statute it implements. *See, e.g., Clark v. United States*, 220 Ct.Cl. —, 599 F.2d 411 (1979); *Farrell Lines, Inc. v. United States*, 204 Ct.Cl. 482, 499 F.2d 587 (1974).

[3] In light of these principles, we conclude that the regulations does not bar reimbursement for the interest the hospitals paid to Indiana University. As the regulation itself indicates, its purpose is to protect the government against paying the cost of collusive loans with inflated interest rates that are designed to benefit enterprises associated with providers of Medicare services. The relationships the regulation describes indicate the evils against which the ban is directed: (1) persons or an organization who control the hospital (*e.g.*, a member of the board of directors or manager); (2) persons or an organization who own the hospital(*e.g.* a commercial venture which runs a proprietary hospital); (3) persons who have a personal relationship with the hospital (*e.g.*, a staff doctor). In each of these instances, the other party, because of its own interests, may unduly influence the hospital's decision to the prejudice of the government if the latter reimburses the hospital for the interest payments.

None of these evils is present in the loan between Indiana University and Indiana University Hospitals. Neither party has a profit motive. To the contrary, Indiana University could have received a greater return on its money by investing it elsewhere. The charged interest, moreover, was far below the market rate, and the loans were made because the university was the sole source the hospitals could turn to for operating capital. The University does not "own" the hospitals; both are State institutions. Its control over the hospitals is also limited. The hospitals receive income not from the University or form the State but from fees charged for their services. They thus are run separately from the education functions of the university which receive direct state funding. The problem of a "personal relation" described in the regulation does not apply to these parties.

The Medicare statute requires reimbursement for the "reasonable costs" of the service provided, and the regulation recognized that "[n]ecessary and proper interest . . is an allowable cost." There is nothing to indicate or even suggest that the interest the hospitals paid to the University, which was below the going rate and was paid to only source from which the hospitals could borrow, was either unnecessary or improper. In light of the purposes of the statute and the regulations as a whole to reimburse providers of Medicare services for their reasonable costs in providing those services, we conclude that the plaintiffs are entitled to reimbursement of the portions of the interest the hospital paid to the University in 1970 and 1971 that are attributable to the provision of Medicare services.

[4] C. Our conclusion also is supported by the settled principle that the statute should be construed so as to avoid any serious doubts concerning its constitutionality. *E.g. Califano v. Yamasaki,* 442 U.S. 82, 89 S.Ct. 2545, 61 L.Ed2d 176 (1979); *United States v. Vuitch,* 402 U.S. 62, 91 S.Ct. 1294, 28 L.ed2d 601 (1971); *United States v. Rumely*, 345 U.S. 41, 78 S.Ct.4543, 97 L.Ed. 770 (1953). The same principle is equally applicable to administrative regulations. *See Rucker*, *supra*, 418 F.2d at 149.

As noted earlier, the regulation has an explicit exception for interest paid to a religious order by a provider operated by members of the order. Denying reimbursement of interest payments by a nonprofit hospital to its affiliated university while permitting reimbursement of payments to an affiliated religious order would raise serious questions under the first amendment, which generally prohibits the government from giving special favored treatment to a religious entity. *E. g., Committee for Public Education & Religious Liberty v. Nyquist*, 413 U.S. 756, 93 S.Ct. 2955, 37 L.Ed.2d 948 (1973); *Lemon v. Kurtzman*, 2105, 29 L.Ed.2d 745 (1971). Our interpretation of the regulation avoids that problems.

Indeed, the explicit exception to the prohibition against reimbursement of interest payments to related persons for religiously affiliated entities further supports our conclusion that the prohibition is directed are no more present where the related person to which the payments are made is a university than where it is a religious order. Since the Secretary specifically expected the latter category from the prohibition, it is reasonable to interpret the regulation as also excepting the former.

In holding for the plaintiffs in this case, we stress the limited scope of our decision. We are not holding that interest payments to a related person are reimbursable wherever the particular relationship does not involve any of the evils against which the regulation is directed. Nor are we casting any doubt upon the authority of the Secretary to adopt his prophylactic regulation generally barring reimbursement of interest payments to related persons, without inquiry into the particular circumstances. *Cf. Pasadena Hospital Association v. United States.*, 618 F.2d 728, (Ct. Cl. No. 317-77, decided today. We hold only that in the particular circumstances of this case—where the nonprofit hospital is affiliated with a State university, the State appropriates no money for the hospital, the hospital is prohibited by State law from borrowing from outside sources, and the borrowing from outside sources, and the university lends the hospital essential funds at less tan the current rate of interest—the prohibition in the regulation against reimbursement of interest paid to a related organization is inapplicable.

CONCLUSION

The plaintiffs are entitled to recover. The defendant's motion for summary judgment is denied, the plaintiffs' motion for summary judgment is granted, and the case is remanded to the Trial Division to determine the amount of recovery pursuant to Rule 131(c).

KUNZIG, Judge, concurring:

I concur with the opinion for plaintiffs in this case and wish to emphasize its consistency with the court's decision issued today in *Pasadena Hospital Association, Ltd. v. United States,* 618 F.2d 728, No. 317-77 (Ct.Cl. 1980) wherein I join the decision for defendant.

First, Pasadena involves a different regulation, 42 C.F.R. § 405.427 "Cost to related organization," the thrust of which is, as the decision in *Pasadena* notes, to define that are includable costs for the purpose of reimbursement. In the instance case the regulation, 42 C.F.R. 405.419(c), is designed to assure that reimbursable interest expenses are reasonable. "The intent of this provision is to assure that loans are legitimate and needed, and that the interest rate if reasonable." 42 C.F.R. § 405.419(c)(1). The refusal to reimburse plaintiffs their interest expenses in *Indiana University* is directly contrary to this explicit purpose. A similar situation does not exist in *Pasadena.*

Second, the decision herein is concerned with avoiding questions of the regulation's validity on constitutional grounds. The regulation draws an exception for interest payments by a provider operated by members of a religious order made to that order. Denying reimbursement to nonprofit Indiana University Hospitals yet permitting interest payment reimbursement to an affiliated religious order could well raise a first amendment question. Our decision herein avoids that problem. This factor is entirely absent from the court's consideration of *Pasadena.*

These two aspects of Indiana University, the different nature of the regulation involved, the presence of the constitutional question, plus the unique factorial circumstances enumerated herein, serve clearly to distinguish this case from the approach outlined in *Pasadena.*

APPENDIX H

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PROVIDER REIMBURSEMENT REVIEW BOARD

In the Matters of:

UNIVERSITY OF CALIFORNIA,
LOS ANGELES MEDICAL CENTER
10883 Le Conte Avenue
Los Angeles, California 90024

PRRB Nos. 86-0548G, 85-0333, 85-418, 86-1721, and 86-0923

UNIVERSITY OF CALIFORNIA
IRVINE MEDICAL CNETER
101 City Drive South
Orange, California 92668

UNIVERSITY OF CALIFORNIA
SANDIEGO MEDICAL CENTER
225 Dickinson Street
San Diego, California 92103

FISCAL PERIODS ENDING:
June 30, 1982, June 30, 1983,
June 30, 1984, and June 30, 1985

STIPULATION OF FACTS

The provider, The Regents of the University of California (The Regents), and the intermediary, Blue Cross of California (Blue Cross) submit this Stipulation of Facts to the Provider Reimbursement Review Board (PRRB) in order to assist PRRB in the adjudication of PRRB Case Nos. 86-0548G, 85-0333, 85-418, 86-1721 and 86-0923. Both The Regents and Blue Cross stipulate and agree that evidence need not be adduced to prove the following facts, and that PRRB should assume the truth of this stipulation for the purposes of adjudication of the above-mentioned cases. Both parties reserve the right to introduce additional evidence at hearing in order to supplement or explain statements made in this stipulation.

1. The providers, University of California, Los Angeles Medical Center (UCLA Medical Center), University of California, Irvine Medical Center (UCI Medical Center), and University of California, San Diego Medical Center (UCSD Medical Center) are general acute care hospitals licensed to The Regents. During the fiscal years applicable to these appeals, The Regents was licensed to operate five general acute care teaching hospitals and two psychiatric hospitals connected with health science campuses and schools of medicine located in Davis, San Francisco, Irvine, La Jolla and Los Angeles, California. The Regents operated the five medical centers and two psychiatric hospitals in order to provide medical education in appropriate academic, as well as clinical, settings. In 1982 and 1983 UCLA Medical Center was licensed for 711 beds and offered a full range of inpatient services, diagnostic services, and ambulatory care program with over 127 clinics and a level-one trauma center. In 1983 and 1985 UCI Medical Center was licensed for 493 beds and offered a full range of inpatient services, diagnostic services, an ambulatory care program with over 15 clinics and a level-one trauma center. In 1982 and 1984 UCSD Medical Center was licensed for 440 beds and offered a full range of inpatient services, di-

agnostic services, an ambulatory care program with over 22 clinics and a level-one trauma center.

2. The Regents operates and operated UCLA Medical Center, UCI Medical Center and UCSD Medical Center pursuant to article IX, section of the California Constitution which provides in relevant part as follows:

> "The University of California shall constitute a public trust, to be administered by the existing corporation known as 'the Regents of the University of California,' with full powers of organization and government, subject only to such legislative control as may be necessary to insure the security of its funds in compliance with the terms of the endowments of the university."

Subsection (f) of article IX, section 9 of the California Constitution grants the University powers necessary and convenient for the effective administration of the trust including the power to sue and be sued and to delegate to its committees, to the faculty of the university or to others, authority of functions as the University deems wise.

Section 66500 of the California Education Code implements article IX, section 9 of the California Constitution with respect to medical education by providing in relevant part the following:

> "It [the University] shall have exclusive jurisdiction in public higher education over instruction in the profession of law and over graduate instruction in the professions of medicine, dentistry and veterinary medicine. It has the sole authority in public higher education to award the doctoral degree in all fields of learning . . . ."

3. UCLA Medical Center, UCI Medical Center and UCSD Medical Center are not separate legal entities from the University. UCLA Medical Center, UCI Medical Center and

UCSD Medical Center are related to the University—they are part of the same organization.

4. UCLA Medical Center, UCI Medical Center and UCSD Medical Center cannot sue or be sued, enter into contracts or perform other legal functions in their own names. Each is precluded from borrowing monies from outside sources.

5. During the 1981-82 year, UCLA Medical Center received a working-capital loan from The Regents paying an annual interest rate of 6.33 percent. The prime interest rate averaged 17.5 percent during 1981-82. Funds were borrowed from the University's Short-Term Investment Pool. During 1981-82, this pool earned an average of 13.74 percent.

6. During the 1981-82 year, UCSD Medical Center received a working-capital loan from the Regents paying an annual interest rate of 6.3 percent. The prime interest rate averaged 17.52 percent during 1981-1982. Funds were borrowed from the University's Short-Term Investment Pool. During 1981-1982, this pool earned an average of 13.74 percent.

7. During the 1982-1983 year, UCLA Medical Center received a working-capital loan from the Regents paying an annual interest rate of 9.04 percent. The prime interest rate averaged 12.01 percent during 1982-1983. Funds were borrowed from the University's Short-Term Investment Pool. During 1982-1983 this pool earned an average of 11.13 percent.

8. During the 1982-1983 year, UCI Medical Center received a working-capital loan from the Regents paying an annual interest rate of 9.04 percent. The prime interest rate averaged 12.01 percent during 1982-1983. Funds were borrowed from the University's Short-Term Investment Pool. During 1982-1983 this pool earned an average of 11.13 percent.

9. During the 1983-1984 year, UCSD Medical Center received a working-capital loan from the Regents paying an

annual interest rate of 9.27 percent. The prime interest rate averaged 11.29 percent during 1983-1984. Funds were borrowed from the University's Short-Term Investment Pool. During 1983-1984 this pool earned an average of 10.13 percent.

10. During the 1984-1985 year, UCI Medical Center received a working capital loan from the Regents paying an annual interest rate of 9.29 percent. The prime interest rate averaged 11.30 percent during 1984-1985. Funds were borrowed from the University's Short-Term Investment Pool. During 1984-1985 this pool earned an average of 10.57 percent.

11. Working capital loans made by the University to UCLA Medical Center, UCI Medical Center and UCSD Medical Center during 1981, 1982, 1983, 1984 and 1985 were used to meet current financial obligations of each respective medical center including payroll, medical supplies and the purchase of necessary professional services and minor equipment. Funds obtained were used for necessary and proper purposes related to patient care within the meaning of 42 Code of Federal Regulations section 413.9.

12. The Short-Term Investment Pool of the University receives cash from various sources including campus plant and loans funds, revenue bond funds, invested endowments, the University retirement system and others. The net cash balance of these funds is invested daily by the Treasurer of the University. On a quarterly basis, the investment income earned by each fund is calculated and distributed.

13. At a meeting of The Regents on June 16, 1972, a formal policy with respect to working capital was developed. In essence, the policy provided that the President of the University, on recommendation of the chancellor concerned, would approve a maximum line of credit for each hospital. Interest on working capital would be charged with 60 days of working capital free of interest, and, after four years, 45 days

of working capital free of interest. Attached hereto as Exhibit 1, and incorporated by this reference, is the action item of the Board of Regents, as well as the implementing policy of the university administration. [Attachment omitted.]

14. During the 1976-77 year, and as a result of severe fiscal problems of University hospitals, the Legislature of the State of California appropriated a $25 million fund entitled University of California Teaching Hospital revolving fund. This fund was to be used for the University hospital's working capital requirements along with other funds of the University. The revolving fund of $25 million was supplemented by University funds with hospitals continuing to receive 45 days of University funded working capital free. Attached hereto as Exhibit 2, and incorporate by this reference, is the legislation and policy of the University of California effective with the 1976-77 year. [Attachment omitted.] As a result of a state budget crisis, the $25 million in working capital funds was withdrawn from the University during the 1980-81 fiscal year.

15. Because the State of California withdrew financial operating support for University hospitals, alternative means of providing for the working capital needs of the University hospitals had to be found. On January 22, 1981, a new policy was implemented in recognition that the state would no longer appropriate funds for working capital needs of University hospitals. The policy of charging interest on working capital is reflected in the University of California accounting manual, an official policy of the University. It is attached hereto as Exhibit 3 and incorporated by this reference. [Attachment omitted.]

16. Attached as Exhibit 4, and incorporated by this reference, is a statement of University administration regarding the source of funds for supporting working capital needs. [Attachment omitted.]

17. Attached hereto as Exhibits 5, 6 and 7 respectively, and incorporated by this reference, are the relevant portions of

The Regents' budget, Governor's budget and the budget act relating to the health science campuses of the University of California for the 1981-82 year. [Attachments omitted.]

18. Attached hereto as Exhibit 8, and incorporated by this reference, is a decision by the California Department of Health Services in Audit Appeal No. HA5-0682-709 dated January 2, 1987. [Attachment omitted.]

JAMES E. HOLST
JOHN F. LUNDBERG
ROBERT BARNES

Dated: 1-30-92

By /s/ Robert Barnes
Robert Barnes

Attorneys for the Regents of the University of California, Provider

Dated: 1-21-92

By /s/ Bernard Talbert,
Bernard Talbert, Attorney for Blue Cross of California, Intermediary

Supreme Court, U. S.
FILED
OCT 16 1996
CLERK

No. 96-90

In the Supreme Court of the United States

OCTOBER TERM, 1996

THE REGENTS OF THE UNIVERSITY OF CALIFORNIA,
PETITIONER

v.

DONNA E. SHALALA,
SECRETARY OF HEALTH AND HUMAN SERVICES, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE FEDERAL RESPONDENT IN OPPOSITION

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14 pp

QUESTION PRESENTED

Whether the Secretary's interpretation of 42 C.F.R. 405.419 (1985), which precludes Medicare reimbursement for interest costs on loans between related organizations, is arbitrary and capricious, an abuse of discretion, or not in accordance with law.

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In the Supreme Court of the United States

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THE REGENTS OF THE UNIVERSITY OF CALIFORNIA,
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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE FEDERAL RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A15) is reported at 82 F.3d 291. The opinion of the district court (Pet. App. A16-A32) is reported at 872 F. Supp. 728. The administrative decision of the Department of Health and Human Services, Provider Reimbursement Review Board (Pet. App. A33-A46) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on April 16, 1996. The petition for a writ of certiorari was filed on July 17, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner filed suit seeking reimbursement for interest costs incurred on loans to three of its university hospitals, the Los Angeles Medical Center, the Irvine Medical Center, and the San Diego Medical Center. All three hospitals are providers under the Medicare program. The Medicare program allows a provider to recover the "reasonable costs" of medical services provided to Medicare patients. 42 U.S.C. 1395x(v)(1)(A). "Reasonable costs" are defined by regulations of the Secretary promulgated at the direction of Congress. 42 U.S.C. 1395x(v)(1)(A); 42 C.F.R. Pt. 405, Subpart D (1985)[1]; see *Thomas Jefferson Univ.* v. *Shalala*, 114 S. Ct. 2381, 2384 (1994) (Section 1395x(v)(1)(A) authorizes the Secretary "to issue regulations defining reimbursable costs and otherwise giving content to the broad outlines of the Medicare statute"). The regulations provide for reimbursement of "[n]ecessary and proper interest" expense. 42 C.F.R. 405.419(a) (1985). "Proper requires that interest [b]e * * * paid to a lender not related through control or ownership, or personal relationship to the borrowing organization." 42 C.F.R. 405.419(b)(3)(ii). "The intent of [the related-party interest rule] is to assure that loans are legitimate and needed, and that the interest rate is reasonable," based on the agency's recognition that a close relationship between the lender and the borrower "could affect the 'bargaining' process that usually accompanies the making of a loan, and could thus be sugges-

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[1] The 1985 regulations govern this case. In 1986, Section 405.419 (1985) was redesignated (without substantial change) as 42 C.F.R. 413.153. See 51 Fed. Reg. 34,790 (1986).

tive of an agreement on higher rates of interest or of unnecessary loans." 42 C.F.R. 405.419(c)(1).

Petitioner made working capital loans to the university hospital providers during Medicare cost years 1982, 1983, 1984 and 1985, and the monies were used for patient care. Pet. App. A4. The loans were precipitated by the hospitals' financial difficulties following a decrease in funding from the state legislature. *Ibid.* The hospital providers' claims for Medicare reimbursement for the interest expenses associated with the loans were denied by the fiscal intermediary under 42 C.F.R. 405.419 (1985). The Provider Reimbursement Review Board affirmed the disallowance of interest expenses. Pet. App. A33-A46. The Administrator of the Health Care Financing Administration declined to review the decision, thus making the Board decision a final agency decision. *Id.* at A47-A48.

2. Petitioner sought review in district court. The district court granted summary judgment in favor of the Secretary. Pet. App. A16-A32. The court of appeals affirmed. *Id.* at A1-A15. The court of appeals concluded that the university hospitals were precluded from receiving Medicare reimbursement for interest expenses on loans from petitioner based on 42 C.F.R. 405.419 (1985), which disallows reimbursement of interest costs from loan transactions between related entities. The court of appeals held that Section 405.419 established a general rule of non-reimbursement, and it rejected petitioner's argument that the related-party interest rule did not apply if the loans were legitimate and necessary and the interest rate was reasonable. Pet. App. A7. The court also held that petitioner lacked standing to challenge the constitutionality of an exception to the related-party

interest rule, 42 C.F.R. 405.419(c)(2) (1985), which allows Medicare reimbursement of interest expenses where the provider borrows from a related religious order. Pet. App. A12-A15.[2]

ARGUMENT

The decision below is correct and does not present a conflict calling for this Court's plenary review.

1. Petitioner principally relies on the decision of the Court of Claims in *Trustees of Indiana Univ.* v. *United States*, 618 F.2d 736 (1980) (Pet. App. A55-A65), which held that Section 405.419 could not be read literally to disallow a university hospital provider to obtain Medicare reimbursement for interest payments on loans it received from the university. Pet. App. A62-A63. The court limited its holding to the "particular circumstances of [that] case—where the nonprofit hospital is affiliated with a State university, the State appropriates no money for the hospital, the hospital is prohibited by State law from borrowing from outside sources, and the university lends the hospital essential funds at less than the current rate of interest." *Id.* at A64.

The Ninth Circuit distinguished the *Indiana* decision on two grounds. Pet. App. A8-A9. First, the hospital providers in *Indiana*, while a part of the University medical center, were separate state institutions and had never received state funding. In contrast, the University of California hospital providers have received state funds in the past. Second, state law in

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[2] The court of appeals also rejected petitioner's argument that Section 405.419 created an irrebuttable presumption in violation of its due process rights. Pet. App. A10-A12. Petitioner does not advance that argument in its petition for certiorari.

Indiana prohibited the hospital providers from receiving state funds. California has no such law. Thus, the court of appeals concluded that "the only way for the hospital in *Indiana* to obtain operating funds was through the University." *Id.* at A9.

In emphasizing the limited scope of its decision, the *Indiana* court explained that it was "not holding that interest payments to a related person are reimbursable wherever the particular relationship does not involve any of the evils against which the regulation is directed." Pet. App. A64. Moreover, the court stated that it did not intend to cast "any doubt upon the authority of the Secretary to adopt his prophylactic regulation generally barring reimbursement of interest payments to related persons, without inquiry into the particular circumstances." *Ibid.*

To the extent that *Indiana* and the decision below are in any tension, *Indiana* is aberrant. Indeed, after *Indiana*, the Court of Claims upheld the general bar against reimbursement of interest from related-party loans in *Jackson Park Hosp. Found.* v. *United States*, 659 F.2d 132, 137-138 (Ct. Cl. 1981). In any event, the Federal Circuit and the Claims Court, which replaced the Court of Claims, no longer have jurisdiction to review reimbursement denials under the Medicare program. See 42 U.S.C. 1395*oo*(f)(1); *St. Vincent's Med. Ctr.* v. *United States*, 32 F.3d 548, 551 (Fed. Cir. 1994); *St. Luke's Med. Ctr.* v. *United States*, 22 Cl. Ct. 322, 329 (1991).

Nor does the decision below conflict with the other decisions cited by petitioner (see Pet. 9). The Sixth Circuit in *Shaker Med. Ctr. Hosp.* v. *Secretary of Health & Human Servs.*, 686 F.2d 1203, 1207-1210 (1982), and *University of Cincinnati* v. *Heckler*, 733 F.2d 1171, 1174-1177 (1984), upheld the validity of

Section 405.419 and denied recovery of interest costs. *Northwest Hosp., Inc.* v. *Hospital Servs. Corp.*, 687 F.2d 985, 990-996 (7th Cir. 1982), involved quite different circumstances; the court there held that the hospital provider could recover interest expenses resulting from loans made by related parties for the purpose of converting the hospital from a profit to a non-profit institution.

Petitioner's argument that Section 405.419 should not have been applied because the purposes of the regulation were not served in this case is inconsistent with the plain language of the regulation, which prohibits reimbursement of interest incurred on debt where the lender is "related through control, ownership, or personal relationship to the borrower." 42 C.F.R. 405.419(c)(1). For petitioner to fault the agency for literally interpreting that regulation stands this Court's long-standing deference to an agency's construction of its own regulation on its head. For instance, in *Thomas Jefferson Univ.* v. *Shalala*, *supra*, the Court upheld the Secretary's interpretation of 42 C.F.R. 413.85(c) (1993), which set forth "a bright line for distinguishing permissible from impermissible reimbursement" of hospitals for certain educational expenses. 114 S. Ct. at 2389. The Court noted that "[w]e must give substantial deference to an agency's interpretation of its own regulations" and that "[o]ur task is not to decide which among several competing interpretations best serves the regulatory purpose." *Id.* at 2386.

As in *Thomas Jefferson Univ.*, the Secretary reasonably interpreted the plain language of Section 405.419 to create an irrebuttable presumption against reimbursement of interest expense from related-party loans. As the court of appeals observed, adop-

tion of petitioner's position would encourage nonprofit organizations that provide operating funds to hospitals "to recharacterize routine, operating capital allocations as 'loans' in order to take advantage of the interest expense reimbursement policy of Medicare." Pet. App. A10. Also, the position urged by petitioner would necessitate the administratively burdensome "case-by-case review the regulations were deigned to avoid." *Ibid.* The court of appeals therefore correctly held that "Congress did not require the Secretary to make exceptions to its policy on related party loans for arguably meritorious transactions involving a specific type of related party." *Id.* at A9. This Court, too, has upheld the validity of prophylactic regulations like Section 405.419. See *Mourning* v. *Family Pubs. Serv., Inc.*, 411 U.S. 356, 373 (1973) ("Since the deterrent effect of the challenged rule clearly implements the objectives of the Act, respondent's contention is reduced to a claim that the rule is void because it requires disclosure by some creditors who do not charge for credit and thus need not be deterred. The fact the regulation may affect such individuals does not impair its otherwise valid purpose."); see also *Weinberger* v. *Salfi*, 422 U.S. 749, 776 (1975) (Although the statute's conclusive presumption "doubtless proves in particular cases to be 'under-inclusive' or 'over-inclusive,' in light of its presumed purpose, it is nonetheless a widely accepted response to legitimate interests in administrative economy and certainty of coverage for those who meet its terms.").[3]

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[3] Petitioner's further contention (Pet. 19-20) that an irrebuttable presumption is inconsistent with the Medicare Act because it may shift Medicare costs to individuals not covered

4. Section 405.419 sets forth limited exceptions to the related-party interest rule, one of which allows for reimbursement of interest costs in cases in which the provider borrows from a related religious order. 42 C.F.R. 405.419(c)(2) (1985). Petitioner argues (Pet. 14-19) that this exception constitutes an unconstitutional preference for religion in violation of the First Amendment's Establishment Clause, but that if Section 405.419 is construed to create only a rebuttable presumption of non-reimbursement, "the constitutional difficulties resulting in the regulation are mitigated." Pet. 15.

However, Section 405.419 is neither ambiguous nor reasonably susceptible to petitioner's interpretation with respect to hospitals generally. Nor would this case be a proper vehicle in which to adjudicate the constitutionality of the exception in Section 405.419(c)(2) for hospitals related to religious orders because, as the court of appeals observed, petitioner conceded below "that it was not challenging the constitutionality of the regulation or the exception." Pet. App. A13; see also Pet. 16 ("[I]t is Petitioner's position that the court, *sua sponte*, should interpret the regulation in question so as to avoid any unconstitutionality under the establishment clause."). Moreover, neither the court of appeals nor the district court addressed the merits of petitioner's argu-

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by Medicare similarly fails. The Medicare Act vested the Secretary with broad authority to define reimbursable "reasonable costs," 42 U.S.C. 1395x(v)(1)(A), and, for the reasons set forth above, Section 405.419's preclusion against interest from related-party loans is a reasonable implementation of the Act. See *Smiley* v. *Citibank (South Dakota), N.A.*, 116 S. Ct. 1730, 1735 (1996).

ment,[4] and there is no conflict among the courts of appeals on the issue.[5]

5. In any event, the interest rule in Section 405.419 has little continuing significance for most hospitals. The Social Security Amendments Act of 1983, 42 U.S.C. 1395ww, generally replaced the "reasonable costs" system of reimbursement with a Prospective Payment System. See *Good Samaritan Hosp.* v. *Shalala*, 508 U.S. 402, 406 n.3 (1993). Effective for cost reporting periods beginning on or after October 1, 1991, the payment methodology for hospital capital costs, such as interest, is governed by the Prospective Payment System, under which payment rates are established with declining regard to the hospital's current "costs" of capital. See 42 C.F.R. 412.304(a) (1996).[6] Under that system, therefore, it is generally

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[4] The court of appeals held that the petitioner lacks standing to challenge the constitutionality of Section 405.419(c)(2) because petitioner has not shown how it is injured by the exception for religiously affiliated providers, and because if the exception were stricken, petitioner would still be subject to the non-reimbursement rule in Section 405.419. Pet. App. A13-A15; see also *Massachusetts* v. *Mellon*, 262 U.S. 447 (1923).

[5] The *Indiana* decision did not adjudicate the validity of Section 405.419(c)(2) but merely noted that a non-literal interpretation of the regulation obviated the need to address the court's concerns about the exception's constitutionality. Pet. App. A63.

[6] Section 412.304 provides for a ten-year transition period, scheduled to be completed by October 1, 2001, during which "the capital payment amount is based on either a combination of payments for old capital costs and new capital costs or a fully prospective rate" that, over the transition period, is based less and less on the individual hospital's actual cost of capital. 42 C.F.R. 412.304(b); 412.340.

irrelevant whether a hospital secures its financing for capital projects from a related party.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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